COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CESR's technical advice to the European Commission on the level 2 measures related to the UCITS management company passport

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Executive Summary

1. CESR received a provisional request for technical advice on possible implementing measures concerning the future UCITS Directive ('the mandate') on 13 February 2009. The Commission's mandate is split into three parts: i) measures related to the UCITS management company passport; ii) measures related to key investor information; and iii) measures related to fund mergers, master-feeder structures and the notification procedure.

2. This document sets out CESR's technical advice to the European Commission on the Level 2 measures in the following areas, all of which are covered under part I of the mandate.

   i) Organisational requirements and conflicts of interest

   The advice follows the clear direction in the Commission's mandate to seek maximum alignment with the MiFID rules in this area, while taking into account the specificities of the UCITS sphere. The paper sets out technical advice on, inter alia, general organisational procedures and arrangements; internal control mechanisms, including responsibility of senior management and the remuneration policy; electronic data processing and record-keeping; and conflicts of interest.

   ii) Rules of conduct

   In line with the advice on organisational requirements and conflicts of interest, the approach taken to the advice on rules of conduct is to seek maximum alignment with the relevant MiFID provisions. The advice includes requirements applying to the direct sale of UCITS by management companies, as well as best execution, order handling and inducements.

   iii) Measures to be taken by a depositary of a UCITS managed by a management company situated in another Member State

   The mandate seeks advice from CESR on additional requirements that should apply to the relationship between the management company and the depositary when these two entities are located in different Member States. Particular focus is placed on the written agreement to be drawn up between the management company and the depositary. Although the mandate clarifies that the implementing measures cover only cross-border situations, the advice would extend their application also to purely domestic arrangements.

   iv) Risk management

   The relevant article of the UCITS Directive sets out the general principle that a management company shall employ a risk management process which enables it to monitor and measure at any time the risk of different positions and their contribution to the overall risk profile of the portfolio. Chapter 1 of this section of the advice sets out more detailed requirements on the basis of this principle in relation to the adequacy of the risk management process. Chapter 2, meanwhile, relates to the requirements on risk measurement for the purposes of calculation of UCITS' global exposure.

   v) Supervisory co-operation

   With a view in particular to ensuring a smooth implementation of the management company passport, the Commission sought advice on two key elements of supervisory co-operation: i) on-the-spot verification and investigation; and ii) exchange of information between competent authorities.

The advice takes into account the existing legal framework in relation to international co-operation, as well as best practice developed within CESR and IOSCO.

Introduction

Background

1. In March 2007, the European Commission announced a series of targeted enhancements to the UCITS Directive. Following further work and consultation, the Commission adopted a proposal for the revised UCITS Directive on 16 July 2008. The European Parliament (at its plenary session of 13 January 2009) and the Council (COREPER meeting of 17 December 2008) approved, in identical terms, a compromise text of a proposal for a Directive containing amendments to the UCITS Directive (85/611/EEC). The Directive was adopted by the Council on 22 June 2009.

2. On the same day as the adoption by the Commission of its Directive proposal (16 July 2008), the Commission requested CESR's technical advice on the conditions that are needed to ensure that a management company passport is consistent with the principle that investors in funds that are managed on a cross-border basis should not be exposed to additional legal and operational risks, or lower standards of supervision than investors in domestically managed UCITS. Following a call for evidence, an open hearing and a short public consultation, CESR delivered its advice to the Commission on 30 October 2008 (Ref. CESR/08-867).

3. In light of the approval of the compromise text by the European Parliament and the Council as outlined above, the Commission prepared a Provisional request to CESR for technical advice on possible implementing measures concerning the future UCITS IV Directive ('the mandate')[1]. The mandate is split into three parts as set out below. This paper sets out CESR's technical advice under Part I.

   Part I – measures related to the management company passport

   This part includes obligatory implementing measures which in some cases must be adopted by the European Commission by 1 July 2010. The following topics are covered: requirements on organisational arrangements, conflicts of interest and rules of conduct for management companies; risk management; additional measures to be taken by depositaries; and issues related to supervisory co-operation. The deadline for delivery of CESR's advice on Part I is 30 October 2009.

   Part II – measures related to key investor information

   This part covers implementing measures on the form and content of key investor information (KII) disclosures for UCITS. The request takes account of the earlier request on KII sent to CESR in April 2007, in response to which CESR submitted a first set of advice in February 2008. The deadline for delivery of CESR's advice on Part II is 30 October 2009.

   Part III – measures related to fund mergers, master-feeder structures and the notification procedure

   The Commission is not under a legal obligation to adopt implementing measures in these areas. As such, the Commission encourages CESR to focus in a first stage on the advice on Parts I and II above. Regarding Part III, the Commission invites CESR to reflect on the best way to organise its work in such a way that all necessary level 2 measures are adopted in time for them to be implemented by Member States within the timeframe imposed by the level 1 Directive.

[1] http://ec.europa.eu/internal_market/investment/docs/legal_texts/ta_mandate_en.pdf

4. Following receipt of the mandate on 13 February 2009, CESR began work to develop its response in view of the deadline for submission to the Commission of 30 October 2009. A call for evidence was published on 17 February 2009 (Ref. CESR/09-179) and CESR received 30 responses. Taking into account responses to the call for evidence and following intensive preparatory work within CESR, a consultation paper was published on 8 July 2009 (Ref. CESR/09-624) to which 26 responses were received. These responses, which are available on CESR's website[2], have been taken into account in the preparation of CESR's advice. CESR's advice has been prepared by the Investment Management Expert Group, which is chaired by Mr Lamberto Cardia, Chairman of the Italian securities regulator, the Commissione Nazionale per le Società e la Borsa (CONSOB).

5. CESR's proposals under Part II (Request for technical advice on the level 2 measures related to the key investor information) are set out in a separate paper, Ref. CESR/09-949. CESR's draft advice on Part III of the mandate (Request for technical advice on the level 2 measures related to fund mergers, master-feeder structures and notification procedure) was published for consultation on 17 September 2009 (Ref. CESR/09-785); responses are due by 17 November.

6. CESR published a separate consultation paper on 15 June 2009 on risk measurement for the purposes of calculation of UCITS' global exposure (Ref. CESR/09-489). The issues covered under that consultation have resulted in the advice set out in Chapter II of Section IV of this document.

Impact of the proposed approach

7. CESR is mindful of the impacts of its proposals. In order to develop a better understanding of the possible costs and benefits of CESR's approach, stakeholders were invited to give specific input on likely impacts – including quantitative estimates wherever possible – of the draft advice. For this purpose, questions on costs and benefits were included throughout the consultation paper. This approach is in line with the request in the Commission's mandate that CESR present appropriate impact assessments in support of its advice.

[2] Call for evidence Ref. CESR/09-179: http://www.cesr.eu/index.php?page=responses&id=132
Consultation Ref. CESR/09-624: http://www.cesr.eu/index.php?page=responses&id=144

Section I
CESR's technical advice to the European Commission on the implementing measures on organisational requirements and conflicts of interest for management companies (Articles 12(3) and 14(2) (a) and (c) of the UCITS Directive)

INTRODUCTION

Background

1. The Commission's mandate asks CESR to advise, inter alia, on the content of the implementing measures on the prudential rules and requirements on conflicts of interest under Art. 12(1)(a) and (b) of the UCITS Directive.

2. In particular, according to that Article: '*competent authorities of the management company's home Member State having regard also to the nature of the UCITS managed by a management company, shall require that each such company:*

(a) has sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms including, in particular, rules for personal transactions by its employees or for the holding or management of investments in financial instruments in order to invest own funds and ensuring, at least, that each transaction involving the UCITS may be reconstructed according to its origin, the parties to it, its nature, and the time and place at which it was effected and that the assets of the common funds or of the investment companies managed by the management company are invested according to the fund rules or the instruments of incorporation and the legal provisions in force;
(b) is structured and organised in such a way as to minimise the risk of UCITS' or clients' interests being prejudiced by conflicts of interest between the company and its clients, between one of its clients and another, between one of its clients and a UCITS and between two UCITS. (…)'

3. CESR should provide its technical advice in the form of an 'articulated' text by 30 October 2009 at the latest.

CESR is requested:

a) to define procedures and arrangements to be implemented by the management company, having regard to the nature of the UCITS managed by the management company (its characteristics and complexity), that meet requirements of Article 12(1)(a),

b) to define the conditions for the structure and organisational requirements of a management company that are necessary for minimizing conflicts of interests as referred to in article 12(1)(b).

General approach

4. The present advice has been prepared taking due account of the overarching principle of a high level of investor protection and supervision, also in the light of the recent developments in the financial markets. The principle of proportionality has also been taken into account, with a view to avoiding the creation of excessive administrative or procedural burdens either on UCITS/management companies or the relevant competent authorities. In addition, the principles laid down in this paper should be considered having in mind that a UCITS may be constituted under different forms (such as an investment company or a contractual fund) and, therefore, adjusted where applicable to the form of the UCITS.

5. In line with the directions given by the Commission in the mandate[3], the present advice seeks as much consistency as possible with the MiFID regime, taking into account the specificities of the collective management business. It should be noted in this respect that management companies performing the investment service of individual portfolio management already comply with the MiFID internal procedures and organisational requirements concerning conflicts of interests[4].

6. Therefore, unless otherwise deemed appropriate in the light of the particular nature of the collective portfolio management business or lessons learned from recent market developments, the suggested approach is to treat the MiFID level 2 provisions as the primary regulatory model for the purpose of CESR's advice. For management companies already providing investment services under MiFID, this approach should limit the implementation costs and help ensure a level playing field in the sector.

7. As mentioned by the Commission in its mandate, the purpose of the level 2 implementing measures on prudential rules and conflict of interests should be to ensure that a management company has sound systems and procedures for avoiding or minimising conflicts of interest. These provisions should be regarded as complementary to those level 2 rules to be provided for in connection with risk management and rules of conduct[5].

8. In line with the approach under MiFID[6], the emphasis of these level 2 measures should be on general obligations to identify and manage conflicts of interest that are capable of application to management companies of different size and type. The ultimate objective should be to prevent that management companies' conflicts of interest adversely affect the interests of the UCITS investors.

9. CESR considers that investment companies should not be treated differently from management companies for the purposes of the definition of the required internal organisation, procedures and conflicts of interest. Therefore, and without prejudice to the responsibility of the board of directors of investment companies having designated a management company, this advice should apply both to management companies and investment companies that have not designated a management company (self-managed UCITS), taking into account the principle of proportionality. Any reference in Part I of the advice to management companies should accordingly be read also as a reference to such investment companies.

10. CESR acknowledges that, as far as allowed by national law, management companies may make arrangements for third parties to carry out some of their activities. This advice must be read accordingly. The management company will in particular perform a due diligence in order to determine whether, having regard to the nature of the functions to be carried out by third parties, the undertaking performing those activities can be considered as qualified and capable of undertaking the functions in question. This implies that the third party will have to fulfil all the organisational and conflicts of interest requirements in relation to the activity to be carried out. It also follows that the management company will have to verify that the third party has taken the appropriate measures in order to comply with the said requirements and will have to monitor effectively the compliance by the third party with these requirements. This implies, in the field of the delegated activities, where the delegatee applies effectively the rules governing the delegated activities, that the relevant organisational and conflict of interests requirements will apply, mutatis mutandis, to the activity of monitoring of the delegated activities. The management company may take into account in the due diligence process the fact that the third party to whom activities are delegated is submitted itself to MiFID. The advice must be construed consistently

[3] See pages 4 and 7 of the mandate. In CESR's technical advice on the UCITS Management Company Passport, it is also recognised that a broad harmonisation could allow for a full alignment of the UCITS Directive to the MiFID.
[4] Article 6(4) of the UCITS Directive states that Articles 2(2), 12, 13 and 19 of MiFID apply to the provision of the service of individual portfolio management by UCITS management companies.
[5] See p.7 of the mandate
[6] See *CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments*, 1st Set of Mandates, January 2005, particularly p. 41.

with the principle that in no case shall the management company's or the depositary's liability be affected by the fact that the management company makes arrangements for third parties to carry out certain activities; nor shall the management company make such arrangements to the extent that it becomes a letter-box entity. The arrangements with third parties may never be used to circumvent the provisions of the UCITS Directive, including the requirements on organisation and conflicts of interest.

14. Direct distribution of both units of UCITS managed by the management company itself and managed by other management companies is a permissible activity of UCITS management companies as set out by Recital 12 of the Directive. CESR considers, therefore, that the activity of direct distribution should be subject to regulatory requirements as it raises regulatory concerns, and that the application of MiFID standards to this activity would ensure a level playing field with intermediated distribution. However, CESR recognises that the work carried out by the European Commission as set out in its communication of 29 April 2009 on Packaged Retail Investment Products (PRIPs)[7] will address the issue of direct distribution, as well as disclosure to investors, with a view to ensuring a consistent approach to the retail distribution of substitute investment products, improving investor protection and addressing level playing field issues.

15. In line with the Commission's mandate, Part I of the advice deals only with the provision by management companies of collective portfolio management to UCITS (leaving out of the scope non-UCITS managed by UCITS management companies). Nonetheless, CESR recommends that the same approach, where relevant, is followed at national level for non-UCITS managed by UCITS management companies.

[7] http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_communication_en.pdf

DEFINITIONS

'CIU' has the same meaning as 'collective investment undertaking' under the UCITS Directive and includes UCITS.

'Client' means any natural or legal person, or any other undertaking (including UCITS), to whom a management company provides activities of collective portfolio management or services in the meaning of Article 6, paragraph 3 of the UCITS Directive.

'Collective portfolio management' means one or more of the functions pertaining to the activity of collective portfolio management as defined under Annex II of the UCITS Directive.

'Delegation' means delegation of functions to third parties by a management company pursuant to Article 13 of the UCITS Directive.

'Durable medium' should mean any instrument which enables an investor to store information addressed personally to that investor in a way accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored.

'Investor' means any unitholder or potential unitholder.

'UCITS Directive' means the Directive on undertakings for collective investment in transferable securities adopted by the Council on 22 June 2009, following a first-reading agreement with the European Parliament (position of the European Parliament adopted on 13 January 2009).

'MiFID' means Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments.

'MiFID L2 Directive' or 'MiFID Implementing Directive' means the Commission's Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms.

'MiFID L2 Regulation' means the Commission's Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

A person with whom a relevant person has a family relationship means any of the following :
- the spouse of the relevant person or any partner of that person considered by the national law as equivalent to a spouse;
- a dependant child or stepchild of the relevant person;
- any other relative of the relevant person who has shared the same household as the person for at least one year on the date of the personal transaction.

'The mandate' means the European Commission's *Provisional Request to CESR for Technical Advice on Possible Implementing Measures Concerning the Future UCITS Directive*, February 13, 2009.

'Relevant persons' in relation to a management company means any of the following:
(a) a director, partner or equivalent, or manager of the management company;
(b) an employee of the management company, as well as any other natural person whose services are placed at the disposal and under the control of the management company and who is involved in the provision by the management company of collective portfolio management;

(c) a natural person who is directly involved in the provision of services to the management company under a delegation arrangement for the purpose of the provision by the management company of collective portfolio management .

'Senior management' means the persons who effectively direct the business of a management company according to Article 7.1(b) of the UCITS Directive[8].

'Supervisory function' means the function within a management company responsible for the supervision of its senior management[9].

'UCITS' has the same meaning as UCITS in the UCITS Directive.

'Unitholder' means any natural or legal person holding one or more units in a UCITS.

[8] The persons vested with the role of senior management may vary depending on the provisions of company law in force in each Member State and may thus be the entire board.
[9] The persons vested with the role of supervisory function may vary depending on the provisions of company law in force in each Member State and may thus be the entire board.

CHAPTER 1

ORGANISATIONAL REQUIREMENTS

Implementation of Article 12(1)(a) of UCITS Directive

MiFID rules which may be adapted to the UCITS context

1. Article 12(1)(a) of the UCITS Directive requires that each management company, having regard also to the nature of the UCITS managed, has: (i) sound administrative and accounting procedures, (ii) control and safeguard arrangements for electronic data processing and (iii) adequate internal control mechanisms. These should include rules on personal transactions or investments of own funds, recordkeeping and compliance (including with the law, fund rules and instruments of incorporation).

2. As noted by the Commission, these structural and organisational aspects of the management company constitute the organisational and procedural basis for the overall risk management process[10]. In CESR's technical advice on the UCITS Management Company Passport it is also recognised that a broad harmonisation could allow for a full alignment of the UCITS Directive to the MiFID. CESR's proposed approach, with a view to avoiding duplication and unjustified burdens for management companies providing the service of individual portfolio management, is that the UCITS level 2 implementing measures on procedures and arrangements of such companies are as much as possible consistent with relevant MiFID L2 Directive rules.

3. The measures of the MiFID L2 Directive which are relevant in this area may be identified in Articles 5 (General organisational requirements), 6 (Compliance), 8 (Internal Audit), 9 (Responsibility of senior management), 10 (Complaints handling), 11 (Meaning of personal transaction), and 12 (Personal transactions)[11]. These articles from the MiFID L2 Directive are set out in Annex 1.

4. For recordkeeping requirements reference should be made to Article 51 of the MiFID L2 Directive and to Articles 7 and 8 of the MiFID L2 Regulation. These Articles from the MiFID L2 Directive and Regulation are set out in Annex 2.

5. The content of these MiFID provisions appears flexible enough for application – with minor adjustments – to UCITS management companies, as analysed below.

Impacts of the proposed approach

6. CESR is mindful of the potential impacts of applying organisational requirements similar to the MiFID requirements to the collective portfolio management business of UCITS management companies.

7. The actual impact of implementing the advice in this paper depends on how much this will change the internal policies and behaviour of UCITS management companies. This depends on whether management companies already apply the proposed rules or whether on a national level there is already a degree of read-across of MiFID provisions to the collective portfolio management business of UCITS management companies.

[10] See page 7 of the Commission's mandate.

[11] Another relevant MiFID L2 Directive measure in this area is Article 7 (Risk management). This Article has been taken into account in the preparation of CESR's advice on risk management, set out in Part IV of this paper.

8. In order to get a full picture about this situation, CESR carried out a survey among its Members to establish the extent of read-across of MiFID provisions to the collective portfolio management business of UCITS management companies.

9. The survey showed a significant variation in regulatory practices across CESR Members. On one end of the scale, several Members have a near complete read-across of MiFID provisions on organisational requirements for the collective portfolio management business of UCITS management companies. On the other end of the scale, there are a few Members where there is only a small extent of read-across, with the regulatory practices of many CESR Members lying between these boundaries.

10. As the current regulatory situation varies across Member States, CESR was very much interested in the views of stakeholders about the impacts i.e. the costs and benefits of the proposals on organisational requirements. The responses to the consultation were taken into account by CESR in providing its final advice to the Commission.

Sound organisational procedures and arrangements for management companies

Level 2 Advice

Box 1

General organisational procedures and arrangements for management companies

1. Management companies should comply with the following requirements:

(a) to establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities;

(b) to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;

(c) to establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the management company;

(d) to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them;

(e) to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the management company as well as effective information flows with any third party involved, including the depository, distributors and any other third party which performs activities on behalf of the management company, in such a way that those parties receive all information deemed to be necessary to perform their duties adequately;

(f) to maintain adequate and orderly records of their business and internal organisation;

(g) to ensure that the performance of multiple functions by their relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly, and professionally.

For those purposes, management companies should take into account the nature, scale and complexity of the business of the management company, and the nature and range of services and activities undertaken in the course of that business.

2. Management companies should establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.

3. Management companies should establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities.

4. Management companies should establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules.

5. Management companies should monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements established in accordance with paragraphs 1 to 4, and to take appropriate measures to address any deficiencies.

Explanatory text

11. Management companies should adopt, apply and maintain sound administrative and accounting procedures in order to ensure compliance with their obligations of proper conduct and transparency in the provision of each collective portfolio management activity and with reference to each managed UCITS. The same principle applies to investment firms in the scope of MiFID (see Art.13 of MIFID).

12. Article 5 of the MiFID L2 Directive provides for high level principles concerning the general internal organisational requirements for investment firms. The provision identifies the fundamental procedures and arrangements that should be established by all investment firms to ensure their proper functioning, regardless of their size or operations. As stated by the European Commission, this rule constitutes a sort of 'common organisational denominator' applicable to such firms[12].

13. In line with this MiFID L2 approach, the implementing provisions of the UCITS Directive should firstly provide for high level principles focusing on the overall organisation of the management company.

14. These principles should contemplate all measures required under Article 5 of the MiFID L2 Directive, including the establishment of a well-documented organisational structure that clearly assigns responsibilities, incorporates proper internal control mechanisms, and ensures good flows of information with all parties involved (including with the depository, distributors and any other third party performing activities on behalf of the management company) in such a way that those parties receive all necessary information to perform adequately their duties. Management companies should be required to employ personnel with the right skills, knowledge and experience, establish adequate systems to safeguard information and ensure business continuity and maintain proper accounting.

15. Even though these principles should have general relevance for all management companies, their tenor is flexible enough to ensure that application is proportionate and takes into account the nature, scale and complexity of a management company's business, including the nature of the UCITS it manages. Indeed, the advice deliberately avoids setting rigid rules for all management companies, considering the diversity – in terms of scale and complexity of the business – of the companies falling within the scope of application of the UCITS Directive.

16. On this basis, while imposing certain fundamental general regulatory requirements to all management companies, the regulatory regime should be adapted to the diverse size and structure of the management company and to the nature of the managed UCITS. Due to their general nature, these requirements can be calibrated in an appropriate and proportionate manner, which duly reflects the specific characteristics and operation of the management company. Indeed, the responsibility to design and adopt measures which are best suited to the particular nature and circumstances of the business should rest with the management company itself.

[12] See the European Commission's Background Note for the draft MiFID Implementing Directive, paragraph 3.1 on p.7: http://ec.europa.eu/internal_market/securities/docs/isd/dir-2004-39-implement/dir-backgroundnote_en.pdf

Internal control mechanisms: responsibility of senior management, compliance, internal audit and complaints handling

Level 2 advice

Box 2

Responsibility of senior management

1. Management companies should, when allocating functions internally, ensure that senior management, and, where appropriate, the supervisory function, are responsible for ensuring that the management company complies with its obligations under the UCITS Directive.

In particular, senior management and, where appropriate, the supervisory function shall be required to assess and periodically to review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations under UCITS Directive and to take appropriate measures to address any deficiencies.

2. Management companies should ensure that their senior management receive on a frequent basis, and at least annually, written reports on the matters of compliance, risk management and internal audit, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies.

3. Management companies should ensure that the supervisory function, if any, receives on a regular basis written reports on the same matters.

Explanatory text

17. In line with the MiFID approach, the principles set out in this advice are intended to be sufficiently flexible to adapt to the different organisational structures within management companies, such as those resulting from different legal and governance systems. The application of the relevant provisions should be left to Member States, since the precise structure and functions of the senior management and of the supervisory function may differ from company to company and from Member State to Member State.

18. In particular, the provision of information and allocation of responsibility to the senior management and supervisory function (if any) of a management company should be consistent with the role and responsibilities of the senior management and supervisory function under applicable national law and corporate governance codes.

19. The senior management comprises persons at the head of the organisation, vested with autonomous power of initiative, decision and control, such as the members of the board and the top managers.

20. The supervisory function may involve a separate supervisory board within a two-tier board structure. In the case of a firm with a unitary board structure, it may involve the establishment of a non-executive committee within the board. However, references to the supervisory function do not include general meetings of the shareholders of a management company or equivalent bodies.

21. CESR considers that the role and responsibilities of the senior management should be central to the definition and implementation of appropriate internal controls and for the allocation of clear tasks and responsibilities with respect to the internal functions of a management company. The senior management should be ultimately responsible for the establishment and maintenance of an appropriate and effective compliance function and, if applicable, internal audit functions. The senior

management should establish, implement and effectively supervise the specific policies associated with each of these functions.

22. In this respect, the role and responsibilities of the senior management of management companies could reflect those established in Article 9 of the MiFID L2 Directive and be adapted to the collective portfolio management activities in order to ensure consistency with the principles on monitoring and internal reporting applicable to risk management contained in CESR's Risk Management Principles for UCITS[13].

23. The primary goal of the compliance function and, where applicable, of the internal audit function should be to provide senior management with systems, controls and other assistance in the discharge of their responsibilities. In particular, it is important that the compliance function has a direct reporting line to senior management, even in cases where, due to the nature, scale and complexity of the business of the management company, and the nature and range of services and activities undertaken in the course of that business, the compliance function is externalised. The senior management should receive periodic information on the adequacy and effectiveness of the internal policies, arrangements and procedures in matters of compliance and on any remedial action taken to address deficiencies.

24. In light of the proportionality principle, CESR recognises that senior management can embed the internal control functions in the organisation of the management company in different ways. The senior management should carefully evaluate how to structure and single out the internal control functions in proportion to the size and complexity of the management company's business.

Level 2 advice

Box 3

Remuneration policy

1. Management companies should establish, implement and maintain a remuneration policy which is consistent and promotes sound and effective risk management and which does not induce risk taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the UCITS they manage.

2. The remuneration policy should be applied to the staff whose activities materially impact the risk profile of UCITS managed by the management company and should be in line with principles related to the protection of the interests of clients and investors in the course of collective portfolio management activities and other services provided.

3. The remuneration policy should include measures to avoid conflicts of interest.

4. The remuneration policy should be clear and documented and should be internally transparent.

5. The remuneration policy should be reviewed annually and be made available on request to the UCITS managed.

25. Having considered the Recommendation of the European Commission on remuneration policies in the financial services sector of 30 April 2009[14], CESR advises that similar key principles regarding the remuneration of the staff whose activities materially impact the risk profile of the UCITS managed by

[13] Ref. CESR/09-178 published on 27 February 2009

[14] http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf

the management company, including the senior management, should be applied to management companies.

26. Remuneration practices may strongly hamper sound and effective risk management if oriented towards rewarding short-term profits and giving staff incentives to pursue unduly risky activities. Management companies should establish remuneration policies in a way as to ensure that it does not induce risk taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the UCITS they manage, and that the remuneration of the staff whose activities materially impact the risk profile of the UCITS managed by the management company does not, and is not likely to, lead to conflicts of interest. Moreover, management companies should ensure that the remuneration and incentive structure for this staff is consistent with principles related to the protection of the interests of clients and investors in the course of collective portfolio management activities and other services provided.

27. Consequently, consistently with the EC Recommendations, where remuneration, in particular of senior management, includes a variable component or a bonus, the remuneration policy should be structured with an appropriate balance of fixed and variable remuneration components. The appropriate balance of remuneration components may vary across staff members, according to market conditions and the specific context in which management companies operate, as well as depending on the type of UCITS they manage. Furthermore, where a significant bonus is awarded, the major part of the bonus should be deferred with a minimum deferment period

28. In order to be in line with the protection of the interests of clients and investors, factors other than financial performance should be considered, such as compliance with systems and controls of the management company.

29. Effective governance is a necessary condition for the remuneration policy to be sound. The decision-making process regarding the remuneration policy of a management company should be internally transparent and should be designed in such a way as to avoid conflicts of interest and ensure the independence of the persons involved. The compliance function and, if applicable, the internal audit, should be involved in the design and review of the implementation of the remuneration policy and report to the supervisory function on material weaknesses and shortfalls.

30. CESR notes that the requirement to make the remuneration policy available on request to the UCITS managed in paragraph 5 of Box 3 is only relevant to UCITS that take the form of investment companies, as contractual UCITS do not have a legal personality. As best practice, the remuneration policy could be made available on the website of the management company.

Level 2 Advice

Box 4

Permanent compliance function

1. Management companies should establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the management company to comply with its obligations under the UCITS Directive, as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise their powers effectively under that Directive.

For those purposes, management companies should take into account the nature, scale and complexity of the business of the company, and the nature and range of services and activities undertaken in the course of that business.

2. Management companies should establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:

(a) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures, policies and procedures put in place in accordance with paragraph 1, and the actions taken to address any deficiencies in the management company's compliance with its obligations;

(b) to advise and assist the relevant persons responsible for carrying out services and activities to comply with the management company's obligations under the UCITS Directive.

3. In order to enable the compliance function to discharge its responsibilities properly and independently, management companies should ensure that the following conditions are satisfied:

(a) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;

(b) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting on a frequent basis, and at least annually, to the senior management on matters of compliance, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies;

(c) the relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor;

(d) the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

However, a management company should not be required to comply with point (c) or point (d) if it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, the requirement under that point is not proportionate and that its compliance function continues to be effective.

Explanatory text

31. In line with the approach taken under MiFID, CESR's advice is intended to deliver clear general principles on compliance that can be applied by all types of management company, but that can be adapted to the specific context pursuant to the proportionality principle. In line with Article 6 of the MiFID L2 Directive, management companies should establish and maintain a permanent compliance function which operates independently, has documented status and the authority to discharge its responsibility.

32. The responsibilities of the compliance function should be to monitor and assess on a regular basis that the relevant internal policies and procedures are adequate and effective. The compliance function should also advise and assist the management company's personnel to comply with the company's obligations. The role of internal monitoring performed by the compliance function within a management company is inherently different from the role of the depository under Article 22 of the UCITS Directive. Indeed, the depositary's responsibility is, inter alia, to carry out external monitoring for verifying that the instructions received from the management company do not conflict with the applicable national law or the fund rules.

33. The duty to establish and maintain a permanent and effective compliance function is a fundamental requirement which should always be met irrespective of the size or scope of operation of the management company. Management companies should ensure that the compliance function has sufficient resources, that its personnel have the necessary expertise to enable them to carry out its tasks and is given full access to all information relevant for the performance of their duties. The expertise and qualification of the compliance personnel may be determined on the basis of appropriate professional or regulatory requirements.

34. Nonetheless, the procedures and arrangements for the internal controls should be appropriately calibrated to the dimension and nature of the specific business. The smaller management companies might thus be in a position to justify devoting fewer resources to compliance infrastructure than a larger management company. If the compliance function is carried out by a third party, in accordance with the proportionality principle, the management company should verify that the entity that will carry out the activity meets the requirements concerning this function and adequately monitor how that entity fulfil its function. The entity performing the compliance function should not be involved in the performance of services or activities it monitors, nor should it exercise any other function incompatible with the compliance function. The senior management remains fully responsible for ensuring that the management company has at all times a permanent and effective compliance function when this function is performed by a third party.

35. Management companies should always appoint a natural person as a compliance officer responsible for co-ordinating the various tasks associated with the firm's compliance policies and procedures, as well as for reporting to senior management.

36. Nevertheless, in order to ensure proportionality, the nature of the reporting line or other functional relationship between the persons involved in the compliance function, the compliance officer and senior management should be left to the discretion of the management company, and should reflect the manner in which its business is organised.

37. Similarly, depending on the specific features of the business of a management company, the general principle of independence of the compliance function could be further strengthened by putting in place additional structural requirements. To this purpose management companies could ensure that the compliance staff is prohibited from performing the activities they monitor; and that the management company's remuneration policy does not undermine the objectivity of the compliance function. To ensure flexibility, these requirements of enhanced independence may be waived where their application would be disproportionate, provided that the management company's compliance function remains effective.

Level 2 Advice

Box 5

Internal audit

1. Management companies should, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the management company and which has the following responsibilities:

(a) to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the management company's systems, internal control mechanisms and arrangements;

(b) to issue recommendations based on the result of work carried out in accordance with point (a);

(c) to verify compliance with those recommendations;

(d) to report on a frequent basis, and at least annually, to the senior management in relation to internal audit matters, indicating in particular whether appropriate measures have been taken in the event of any deficiencies.

Explanatory text

38. The internal audit function in a management company could be opportunely organised along the lines of Article 8 of the MiFID L2 Directive. In particular, a separate and independent internal audit function should be established and maintained only where it is appropriate and proportionate in view of the nature, scale and complexity of the business of the management company.

39. The internal audit function should be aimed at ensuring that the company has in place sound internal control mechanisms. To this purpose, the internal audit function should be responsible for establishing, implementing and maintaining an audit plan to examine and evaluate the adequacy and effectiveness of the management company's systems, internal control mechanisms and arrangements. The internal audit should provide information, analysis and recommendations in this regard and it should verify compliance with the recommendations it issues. The expertise and qualification of the internal audit personnel may be determined on the basis of appropriate professional or regulatory requirements.

40. The internal audit function should report regularly to the senior management in order to inform it about the adequacy and effectiveness of the systems and internal control mechanisms.

Level 2 Advice

Box 6

Complaints handling

Management companies should establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from investors, whether or not the management company directly distributed them units of the UCITS.

The management company shall ensure that each complaint is recorded of and that the measures have been taken for its resolution.

An investor should be able to file a complaint free of charge and in an official language of his Member state.

Explanatory text

41. In order to foster investor protection, it is important that management companies establish, implement and maintain effective procedures for handling complaints from (both institutional and retail) investors, and maintain records of such complaints and the measures taken for their resolution.

42. On the basis of the principle of equal treatment, all investors should be entitled to complain to the management company, whether or not the management company directly distributed them units of the UCITS. It is, however, understood that the management company can modulate its policy and procedures concerning the handling of complaints depending on, and taking into account, the nature of the investors (retail or institutional).

43. According to Article 15 of the UCITS Directive, management companies must set up appropriate procedures and arrangements to ensure that they deal properly with investor complaints and that there are no restrictions for investors to exercise their rights in the event that the management company is authorised in a Member State different from the UCITS' home Member State. This entails, inter alia, that management companies must allow investors to file complaints in the official language (or one of the official languages) of their Member State. A sensible reading of this requirement should be that an investor is allowed to file complaints in an official language of a Member State where the UCITS is authorized or notified. In addition the information on the complaints filing must be made available at the request of the public or the competent authority of the UCITS home Member State. The complaints handling policy should be made available free of charge to investors.

44. This provision could be drafted consistently with Article 10 of the MiFID L2 Directive. In particular, management companies should:

    (a) maintain effective and transparent procedures for handling complaints in a reasonable and timely way;

    (b) keep a record of each complaint and the measures taken for its resolution.

Personal transactions

Level 2 Advice

Box 7

Meaning of personal transaction

Personal transaction should mean a trade in a financial instrument effected by or on behalf of a relevant person, where at least one of the following criteria are met:

(a) that relevant person is acting outside the scope of the activities he carries out in that capacity;

(b) the trade is carried out for the account of any of the following persons:
(i) the relevant person;
(ii) any person with whom he has a family relationship, or with whom he has close links;
(iii) a person whose relationship with the relevant person is such that the relevant person has a direct or indirect material interest in the outcome of the trade, other than a fee or commission for the execution of the trade.

Personal transactions

1. Management companies should establish, implement and maintain adequate arrangements aimed at preventing the following activities in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 1(1) of Directive 2003/6/EC or to other confidential information relating to UCITS or transactions with or for UCITS by virtue of an activity carried out by him on behalf of the management company:

(a) entering into a personal transaction which meets at least one of the following criteria:
(i) that person is prohibited from entering into it under Directive 2003/6/EC;
(ii) it involves the misuse or improper disclosure of that confidential information;
(iii) it conflicts or is likely to conflict with an obligation of the management company under the UCITS Directive or under the MiFID;

(b) advising or procuring, other than in the proper course of his employment or contract for services, any other person to enter into a transaction in financial instruments which, if a personal transaction of the relevant person, would be covered by point (a) or Article 25 (2) (a) or (b) of the MiFID Implementing Directive, or would otherwise constitute a misuse of information relating to pending orders;

(c) without prejudice to Article 3(a) of Directive 2003/6/EC, disclosing, other than in the normal course of his employment or contract for services, any information or opinion to any other person if the relevant person knows, or reasonably ought to know, that as a result of that disclosure that other person will or would be likely to take either of the following steps:
(i) to enter into a transaction in financial instruments which, if a personal transaction of the relevant person, would be covered by point (a) or Article 25 (2) (a) or (b) of the MiFID Implementing Directive, or would otherwise constitute a misuse of information relating to pending orders;
(ii) to advise or procure another person to enter into such a transaction.

2. The arrangements required under paragraph 1 must in particular be designed to ensure that:

(a) each relevant person covered by paragraph 1 is aware of the restrictions on personal transactions, and of the measures established by the management company in connection with personal transactions and disclosure, in accordance with paragraph 1;

(b) the management company is informed promptly of any personal transaction entered into by a relevant person, either by notification of that transaction or by other procedures enabling the management company to identify such transactions. Where certain activities are performed by third parties, the management company must ensure that the entity performing the activity maintains a record of personal transactions entered into by any relevant person and provides that information to the management company promptly on request;

(c) a record is kept of the personal transaction notified to the management company or identified by it, including any authorisation or prohibition in connection with such a transaction.

3. Paragraphs 1 and 2 shall not apply to the following kinds of personal transaction:

(a) personal transactions effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed;

(b) personal transactions in UCITS or units in collective undertakings that are subject to supervision under the law of a Member State which requires an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected are not involved in the management of that undertaking.

Explanatory text

45. Article 12(1)(a) of the UCITS Directive requires that management companies should adopt adequate and appropriate rules governing personal transactions by its relevant employees.

46. The purpose of the relevant UCITS implementing measure should be to ensure that management companies prevent their employees who are subject to conflicts of interest or in possession of inside information from entering into, or procuring other persons to enter into, transactions that would constitute misuse of information they have acquired through their professional activity.

47. The UCITS level 2 provisions could be drafted along the lines of Articles 11 and 12 of the MiFID L2 Directive and should apply the same definition of 'relevant person' indicated under Article 2(3) of the MiFID L2 Directive, but excluding tied agents.

48. On this basis, UCITS implementing provisions could set out the main objectives that a management company should achieve and specify the basic organisational or procedural rules which govern the notification and record-keeping of such personal transactions. The measure should complement and be consistent with Directive 2003/6/EC ('the Market Abuse Directive').

49. Consistently with the MiFID L2 Directive, appropriate exemptions from the rules that prevent the staff of management companies from entering into personal transactions might also be provided for when the transaction is in a UCITS and the relevant person and any other person for whose account the transaction is effected are not involved in the management of that UCITS. This exemption should not affect the scope of obligations under the Market Abuse Directive.

50. The exemption in Article 12(3)(a) of the MiFID L2 Directive concerning personal transactions effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed – is already applicable to management companies providing ancillary services, according to Article 1(2) of the MiFID L2 Directive.

Electronic data processing and recordkeeping requirements

Level 2 Advice

Box 8

Recordkeeping requirements

1. Management companies should for each portfolio transaction relating to UCITS, immediately make a record of information sufficient to reconstruct details on the order and the executed transaction, including:

(a) the name or other designation of the UCITS and of the person acting on account of the UCITS;
(b) details for instruments identification;
(c) quantity;
(d) type of the order/transaction;
(e) price;
(f) date and exact time of the transmission of the order and name or other designation of the person to whom the order was transmitted, or of the decision to deal / execution of the transaction;
(g) person transmitting the order/executing the transaction;
(h) reasons behind the order revocation (if any);
(i) for executed transactions: counterparty and venue identification.

Management companies should retain all the required records for a period of at least five years.

However, competent authorities may, in exceptional circumstances, require management companies to retain any or all of those records for such longer period as is justified by the nature of the instrument or portfolio transaction, if that is necessary to enable the authority to exercise its supervisory functions under the UCITS Directive.

Following the termination of the authorisation of a management company, Member States or competent authorities may require the management company to retain records for the outstanding term of the five year period or, in the event that the management company transfers its responsibilities in relation to the UCITS to another management company, that arrangements are made thatsuch records for the past five years are accessible to that company.

2. The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the competent authority, and in such a form and manner that the following conditions are met:

(a) the competent authority must be able to access them readily and to reconstitute each key stage of the processing of each portfolio transaction;

(b) it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained;

(c) it must not be possible for the records otherwise to be manipulated or altered.

3. The competent authority of each Member State shall draw up and maintain a list of the minimum records management companies are required to keep according to the UCITS Directive and its implementing measures.

Ability to process data electronically

1. Management companies should avail themselves of suitable IT systems which permit a timely and proper recording of each portfolio order/transaction carried out on behalf of each UCITS and client.

2. Management companies should ensure a high level of IT security and integrity and confidentiality of the recorded information.

Recording of subscription and redemption orders

1. Management companies should ensure that the UCITS subscription and redemption orders received from investors, and the relevant terms and conditions, are centralized and recorded in electronic form immediately after receipt of any such order. The procedures put in place in order to avoid malpractices as late trading or market timing should rely on those recordings.

2. The recording should include:
(i) a specific identification of the legal unitholder and the relevant UCITS;
(ii) the identification of the persons receiving the order from the legal unitholder;
(iii) order related information, namely :

- date and time,
- terms and means of payment,
- type,
- execution date,
- number of subscribed/redeemed units/shares,
- subscription/redemption price,
- subscription/redemption value (units/shares x price),
- total consideration (gross amount including charges for subscription, net amount after charges for redemptions),
- amount of each single fee and expense with relevant qualification.

Explanatory text

51. The UCITS Directive requires that management companies should be subject to rules ensuring, at least, that each portfolio transaction involving the UCITS may be reconstructed according to its origin, the parties to it, its nature, and the time and place at which it was executed. In addition, management companies shall have control and safeguard arrangements for electronic data processing.

52. CESR recognises that the prompt availability of information is essential for the good functioning of management companies, since it facilitates appropriate internal decision-making and the pursuit of the UCITS' investment objectives. For this purpose, management companies should maintain administrative procedures that are designed to keep adequate and orderly records of its collective portfolio management business and organisation.

53. In order to avoid unjustified burdens on management companies, the UCITS implementing measures could be established on the basis of the registration requirements provided for under Article 51 of the MiFID L2 Directive and Articles 7 and 8 of the MiFID L2 Regulation, concerning decisions to deal and executed transactions applicable to investment firms.

54. Accordingly, management companies should, for each portfolio transaction relating to the UCITS, immediately make a record of information sufficient to reconstruct details of the orders and the executed transactions, including (a) the name or other designation of the UCITS and of the person acting on account of the UCITS; (b) details for instruments identification; (c) quantity; (d) type of the order/transaction; (e) price; (f) date and exact time of the transmission of the order and name or other designation of the person to whom the order was transmitted, or of the decision to deal / execution of the transaction; (g) person transmitting the order/executing the transaction; (h) reasons behind the order revocation (if any); (i) for executed transactions: counterparty and venue identification.

55. Management companies should be able to process data electronically by availing themselves of suitable IT systems, which should be adequate and proportionate to the nature and scale of the business.

56. The IT systems should permit a timely and proper recording of each portfolio order/transaction carried out on behalf of each UCITS and investor. Moreover, management companies should ensure a high level of IT security and integrity and confidentiality of the recorded information. This implies that, in case of disruption of their IT systems, management companies should ensure the preservation of the recordings or the timely recovery of the data.

57. Management companies and relevant third parties (including the depository and the distributors) should give each other the relevant information in a format and according a process agreed between the relevant parties, with a view to facilitating the exchange of information and electronic flows necessary for the carrying out of their activities and functions. The exchange of information should also ensure that accounting verifications and reconciliations are properly carried out.

58. Furthermore, CESR advises that management companies ensure that the subscription and redemption orders from investors are recorded in electronic form and that the relevant terms and conditions are recorded immediately after receipt of any such order. In order to ensure a level playing field and proper investor protection, the content of such recording should be harmonised and include a specific identification of the investor (in the case of a nominee structure, the nominee should qualify as the legal owner of the UCITS units) and the relevant UCITS, order-related information and indication of relevant subscription or redemption NAV. In addition, the management companies should ensure that all subscription and redemption orders from investors are centralised, being understood that some information concerning the orders may not be centralised such as the identity of the investors and of the amount of the fee paid by the investors directly to the distributor. The procedures put in place by the management company in order to ensure market integrity and avoid malpractice, such as late trading or market timing, should rely on these recordings of subscription and redemption orders.

Additional non-MiFID provisions: organisation principles of the UCITS accounting

Level 2 advice

Box 9

UCITS accounting principles

1. The management company should employ accounting processes and procedures ensuring the protection of unitholders. The UCITS accounting should be kept in such way that at all time all assets and liabilities of the UCITS can be directly identified. If a UCITS has different investment compartments, those investment compartments should hold separate accounts.

2. The management company should establish, implement and maintain accounting processes and procedures to ensure that the calculation of the NAV can be accurately effected on the basis of the accounting and in accordance with the accounting rules of the UCITS's home Member state, and that the orders of subscriptions and redemptions can be properly executed at that NAV.

3. The management company should establish appropriate procedures to ensure proper and accurate valuation of the assets and liabilities of the UCITS in accordance with the applicable valuation rules, including – where relevant – rules mentioned in the prospectus and/or in the instruments of incorporation or the fund rules of the UCITS. The management company should have sufficient resources, expertise and knowledge of the valuation rules.

59. The accounting is one of the key areas of the UCITS' administration and should be considered as part of the organisation of the management company. It is therefore of paramount importance that some basic principles concerning the organisation of the accounting are laid down beyond the MiFID L2 rules. Those principles should be considered having in mind paragraph 10 of the General Approach above if the management company delegates the UCITS accounting to a third party (including to the depositary if the law of the UCITS' home Member State allows it). The principle of separation is the foundation of the accounting organisation. The accounting books of each UCITS and, if a UCITS has different investment compartments, each investment compartment should be fully separated, without prejudice to national rules on pooling techniques provided those rules comply with the UCITS directive. The purpose of this principle is to ensure that all assets and liabilities of a UCITS or of its investment compartments can be directly identified. In addition, if different share classes exist (e.g. depending on the level of management fees), it should be possible to extract directly from the accounting the net asset value of those different classes.

60. Subscriptions and redemptions are executed at the net asset value with the periodicity mentioned in the UCITS prospectus and / or instruments of incorporation or fund rules (the execution dates). On each execution date, it should be possible to calculate accurately the net asset value of the UCITS units on the basis of the accountancy (taking into consideration the existing investment compartments and/or share classes). This implies that a complete inventory of the assets and liabilities is made on each execution date and that all portfolio transactions on the assets are recorded in the accounting at the date on which the transaction took place (including all pro rata of profits and expenses). The software used for the accounting should be able to provide automatically a balance sheet and a profit and loss account for each managed UCITS (or investment compartments thereof). This should not prevent that some "off system" processes are used (derivative valuation, complex tax provisioning,...) to calculate the final NAV.

61. Consistently with Article 19(3) of the UCITS Directive, the management company should establish appropriate internal procedures to ensure that the valuation of assets and the accounting of the UCITS is carried out according to the rules of the UCITS home Member State and any additional rules that may be mentioned in the UCITS prospectus and/or in its instruments of incorporation or fund rules.

Additional non-MiFID provisions: implementation of investment strategies

Level 2 Advice

Box 10

Implementation of the general investment policy

1. The responsibility for the implementation of the general investment policy[15] defined in the relevant prospectus and/or articles of incorporation or fund rules should rest with the senior management of management companies. To this purpose, the senior management should approve the investment strategies of each UCITS they manage. The investment strategies are understood as a set of general indications concerning the strategic asset allocation of the UCITS and the investment techniques which are needed to adequately and effectively implement the investment policy.

2. The senior management should ensure and verify periodically that the general investment policy and the investment strategies as well as the risk limits of each managed UCITS are properly and effectively implemented and complied with. Senior management should also approve and periodically review the adequacy of the internal procedures for undertaking investment decisions in order to ensure that these decisions are consistent with the approved investment strategies.

3. Management companies should ensure that senior management receives on a regular basis written reports on the implementation of investment strategies and of the internal procedures for the undertaking of investment decisions.

4. Management companies should keep evidence on the provision of collective portfolio management activities and of the analyses and monitoring performed.

Explanatory text

62. The provisions of the MiFID L2 Directive could be supplemented by specific organisational provisions aimed at ensuring the proper implementation of the general investment policy of the UCITS i.e. the set of limits regarding the portfolio composition of the fund as established in the prospectus, the fund rules or instruments of incorporation. This issue could be linked with the level 3 principles already agreed with respect to risk management.

63. The primary responsibility to ensure that UCITS assets are invested in accordance with the prospectus and/or the fund rules or the instrument of incorporation and the legal provisions in force should be with senior management of the management company (see also CESR's Risk management principles for UCITS).

64. In particular, UCITS level 2 provisions should establish that senior management of management companies should implement the general investment policies defined in the UCITS prospectus and/or their articles of incorporation or fund rules by approving the appropriate investment strategies for each managed UCITS. The investment strategies shall be intended as a set of general indications concerning the strategic asset allocation of the UCITS and the investment techniques which are needed to adequately and effectively implement the investment policy and to coordinate the investment decisions made at the front end level (by the persons in charge of the portfolio management).

65. The investment strategies must be consistent with the general investment policy of the UCITS defined in the fund rules, prospectus or instruments of incorporation. Considering the significance of the

[15] General investment policy should be understood as investment objectives and policy within the meaning of the key investor information.

investment strategies for the proper provision of collective management activities, the definition of the investment strategies of a UCITS should be under the competence of the collegial body holding the highest level of corporate responsibility within the management company i.e. the board of directors (or equivalent body e.g. the executive committee).

66. The senior management should also ensure that the investment strategy of each managed UCITS is consistent with its risk limit system (as defined by the level 3 principles already agreed with respect to risk management). In addition, the senior management should verify periodically that the investment strategies adopted are properly and effectively implemented and that those strategies comply on an ongoing basis with the legal requirements and with the rules laid down in the relevant UCITS prospectus and/or articles of incorporation or fund rules.

67. The investment strategies should be implemented through appropriate internal procedures for undertaking investment decisions. Senior management should also approve and periodically review the adequacy of the internal procedures for undertaking investment decisions.

68. In order to be able to verify that the investment strategies are properly implemented and that the internal procedures for undertaking investment decisions are adequate, senior management should receive on a regular basis written reports on the application of investment strategies and the internal procedures for the undertaking of investment decisions.

69. Considering the importance of maintaining proper evidence of investment strategies and activities, for each UCITS managed, management companies should retain documentation on the provision of collective portfolio management, containing the strategies defined and the analyses and monitoring performed.

Additional non-MiFID provisions: Implementation of strategies for the exercise of voting rights

Level 2 Advice

Box 11

Implementation of strategies for the exercise of voting rights

1. Management companies should, to the exclusive benefit of unit-holders, apply adequate and effective strategies to define if and how the voting rights attached to the instruments held in the managed portfolios are exercised..

2. The strategy should define the measures and procedures to:

(a) monitor the relevant corporate events; and

(b) evaluate timing and modalities for the exercise of the votes, in accordance with the investment objectives and policy of the relevant UCITS;

(c) prevent or manage conflict of interest arising from the exercise of voting rights .

3. An updated summary description of these strategies should be made available to the investors. In addition, the way these strategies are actually implemented should be made available to the unitholders free of charge and on their request.

70. In order to better protect investors in UCITS, CESR believes that it is important to introduce specific level 2 provisions concerning the arrangements in place for the exercise of voting rights attaching to the financial instruments of the managed UCITS. This should not prevent Member States from applying more stringent rules at national level.

71. In this respect, management companies should be requested to adopt, apply and maintain an effective and adequate strategy for the exercise of the voting rights attaching to the financial instruments pertaining to the managed UCITS, with a view of ensuring that such rights are exercised to the exclusive benefit of unitholders. As the case may be, the decision to not exercise the voting rights in certain circumstances, or depending on the investment strategy of the relevant UCITS (for example, UCITS following a passive investment policy such as the index funds), could be considered as protecting the exclusive benefit of the unitholders. Information on this strategy should be made available to the investors (i.e. unitholders and potential unitholders but the way it was actually implemented should be made available only to unitholders. This information could include reporting on if and how voting rights have been exercised. Finally, CESR would like to make clear that the requirements of Box 11 on the voting rights are without prejudice to the possibility for an investment company to vote itself or to give specific voting instructions to the management company.

CHAPTER 2

CONFLICTS OF INTEREST

Implementation of Article 12(1)(b) of the UCITS Directive

Identification of possible relevant MiFID provisions

1. Article 12(1)(b) of the UCITS Directive requires that each management company, having regard also to the nature of the UCITS managed, is structured and organised in such a way as to minimise the risk of UCITS' or clients' interests being prejudiced by conflicts of interest (i) between the management company and its clients; (ii) between one of its clients and another; (iii) between one of its clients and a UCITS; and (iv) between two UCITS.

2. The MiFID L2 Directive provisions which specify the concrete organisational requirements and procedures for the identification, prevention, management and disclosure of conflicts of interest are Article 21 (Conflicts of interest potentially detrimental to a client), Article 22 (Conflicts of interest policy) and Article 23 (Record of services or activities giving rise to detrimental conflict of interest). These Articles are set out in Annex 3.

3. The aim of these rules is to ensure that investment firms take a holistic approach to conflicts management, regularly reviewing their business lines to ensure that at all times their policies reflect the full scope of their activities and the possible conflicts that may emerge[16].

4. Considering the nature of the MiFID provisions mentioned above, they could be suitably used as a model to forge possible level 2 implementing measures on the internal structure and organisation of UCITS management companies in connection with the prevention and management of conflicts of interest. Nonetheless, this MiFID regulatory framework may need to be adapted in order to accommodate the peculiarities of the collective portfolio management business.

Impacts of the proposed approach

5. CESR is mindful of the potential impacts of applying requirements on conflicts of interest which are similar to MiFID requirements to UCITS management companies.

6. The actual impact of implementing the proposals described in Chapter 2 of this part of the advice depends on how much this will change the internal policies and behaviour of management companies. This depends on whether management companies already apply the proposed rules or whether on a national level there is already a degree of read-across of MiFID provisions to the collective portfolio management business of UCITS management companies.

7. As stated in paragraph 8 of Chapter 1 of this paper, CESR carried out a survey among its Members to establish the extent of read-across of MiFID provisions to the collective portfolio management business of UCITS management companies.

8. As in Chapter 1 of this paper, the survey showed a significant variation in regulatory practices across CESR Members. On one end of the scale, several Members have a near complete read-across of MiFID provisions on conflicts of interest for the collective portfolio management business of UCITS management companies. On the other end of the scale, there are a few Members where there is

[16] See EC Background Note of MiFID Implementing Directive, particularly p. 13.

basically no read-across, with the regulatory practices of many CESR Members lying between these boundaries.

Criteria for the identification of conflicts of interest

Level 2 advice

Box 12

Conflicts of interest potentially detrimental to a client of a management company or to an investor.

1. For the purposes of identifying the types of conflict of interest that arise in the course of providing collective portfolio management activities and whose existence may damage the interests of a UCITS, management companies should take into account, by way of minimum criteria, the question of whether the management company or a relevant person, or a person directly or indirectly linked by control to the management company, is in any of the following situations, whether as a result of providing collective portfolio management activities or otherwise:

(a) the management company or that person is likely to make a financial gain, or avoid a financial loss, at the expense of the UCITS;

(b) the management company or that person has an interest in the outcome of a service or an activity provided to the UCITS or another client or of a transaction carried out on behalf of the UCITS or another client, which is distinct from the UCITS interest in that outcome;

(c) the management company or that person has a financial or other incentive to favour the interest of another client or group of clients over the interests of the UCITS;

(d) the management company or that person carries on the same business as the UCITS;

(e) the management company or that person receives or will receive from a person other than the UCITS an inducement in relation to the collective portfolio management activities provided to the UCITS, in the form of monies, goods or services, other than the standard commission or fee for that service.

2. When taking into account the situations possibly giving rise to a conflict, the management companies should consider:

(i) the interests of the management company, including those deriving from its belonging to a group or from the performance of services and activities, the interests of the clients and the duty of the management company towards the UCITS;

(ii) the interests of two or more managed UCITS.

3. Management companies should comply, *mutatis mutandis,* with the above requirements in connection with conflicts of interest which may arise towards investors when the management company directly distributes units of managed UCITS.

Explanatory text

9. Article 21 of the MiFID Implementing Directive concerning the identification of conflicts of interest potentially detrimental to a client could be applied with minor adjustments to management companies.

10. In particular, the provision sets out criteria for determining the types of conflict of interest that arise in the course of providing any services or activities, including individual portfolio management, the existence of which may damage the interests of a UCITS. The provision is not intended to constitute

an exhaustive list, and management companies should be aware that conflicts of interest might arise in other circumstances. The identification of the conflicts in the UCITS context should be consistent with the MiFID approach.

11. The situations and criteria for conflicts identification of Article 21 of the MiFID L2 Directive would seem to fit with the UCITS context. On this basis, UCITS implementing provisions could be formulated consistently with the content of this provision of the MiFID L2 Directive.

12. In particular, for the purposes of identifying conflicts of interest the management companies could take into account whether: (a) there is likelihood of making a financial gain, or avoiding a financial loss, at the expense of the UCITS; (b) there is an interest in the outcome of a service or an activity provided to the UCITS or another client or of a transaction carried out on behalf of a UCITS or another client, which is distinct from the UCITS interest in that outcome (e.g. churning); (c) there is a financial or other incentive to favour the interest of another client, or group of clients, over the interests of the relevant UCITS; (d) it carries on the same business as the UCITS; (e) it is receiving an inducement in the form of monies, goods or services, other than the standard commission or fee for that service.

13. The relevant UCITS implementing provisions could additionally specify that, when taking into account the situations possibly giving rise to a conflict, the management companies should consider both:

    a. the interests of the management company, including those deriving from its belonging to a group or from the performance of services and activities, the interests of the clients and the duty of the management company towards the UCITS; and

    b. the interests of two or more managed UCITS.

14. In the context of direct distribution of UCITS, management companies may face situations of conflicts which might damage the interests of an investor. In such situations, management companies should comply with the above conflicts requirements by making reference to the interests of investors, instead of the interests of the UCITS. Such conflicts may, for example, arise in cases where management companies have incentives to distribute a specific UCITS or in case the remuneration of the persons in charge of the distribution is linked to the number of units distributed.

Procedures for conflicts identification and management

Level 2 advice

Box 13

Conflicts of interest policy

1. Management companies should establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the management company and the nature, scale and complexity of its business.

Where the management company is a member of a group, the policy should also take into account any circumstances, of which the company is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group.

2. The conflicts of interest policy established in accordance with paragraph 1 shall include the following content:

(a) it must identify, with reference to the specific collective portfolio management activities carried out by or on behalf of the management company, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the UCITS or one or more other clients or investors in the case of direct distribution;

(b) it must specify procedures to be followed and measures to be adopted in order to manage such conflicts.

Explanatory text

15. For firms subject to MiFID, the identification and management of conflicts of interest must be made in accordance with Article 22 of the MiFID Implementing Directive (Conflicts of interest policy) which requires that a management company should establish, implement and maintain an effective conflicts of interest policy. This provision could be extended to management companies, including to their senior management. The senior management of the management company and, where appropriate, the supervisory function should be responsible for the proper establishment and implementation of the conflict of interest policy.

16. In line with Article 22(1) of the MiFID L2 Directive, the conflicts of interest policy of management companies should be formulated in writing and should be appropriate to the nature of the UCITS it manages. Where the management company is a member of a group, its policy should take into account any circumstances of which the company is or should be aware, which may give rise to a conflict arising as a result of the structure and business activities of other members of the group and the existing distribution agreements. The policy should take due account of the specific conflicts of interest situations that can arise at the level of senior management.

17. Article 22(2) of the MiFID L2 Directive, which specifies the elements that a management company must necessarily include in its conflict of interest policy, could also be adapted in the context of the collective management business. As a result, the conflict policy of management companies should identify for each category (in terms of organisational model) of UCITS, and with reference to specific collective portfolio management activities, the circumstances which may give rise to a conflict of interest entailing a material risk of damage to the interests of the UCITS or one or more other clients or investors, and specify procedures to be followed and measures to be adopted in order to manage such conflicts.

18. As regards the disclosure of conflicts which may be detrimental to the unitholders (Article 18 of MiFID), see Box 16 and its Explanatory text below.

Independence of the persons managing conflicts

Level 2 advice

Box 14

Independence in the conflicts management

1. The procedures and measures provided for the management of conflicts of interest should be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest carry on those activities at a level of independence appropriate to the size and activities of the management company and of the group to which it belongs, and to the materiality of the risk of damage to the interests of clients or investors in the case of direct distribution.

2. The procedures to be followed and measures to be adopted shall include such of the following as are necessary and appropriate for the management company to ensure the requisite degree of independence:

(a) effective procedures to prevent or control the exchange of information between relevant persons engaged in collective portfolio management activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients or one or more investors in the case of direct distribution;

(b) the separate supervision of relevant persons whose principal functions involve carrying out collective portfolio management activities on behalf of, or providing services to, clients or to investors whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the management company;

(c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;

(d) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities;

(e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities where such involvement may impair the proper management of conflicts of interest.

3. If the adoption or the practice of one or more of those measures and procedures does not ensure the requisite degree of independence, management companies should adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes.

Explanatory text

19. Article 22(3) of the MiFID Implementing Directive addresses the issue of independence in the management of conflicts of interest. CESR proposes that the principles contained in that Article should apply to management companies.

20. In particular, implementing measures of the UCITS Directive should provide that, where persons are engaged in different business activities involving a conflict of interest, the management company should adopt procedures and measures designed to ensure that relevant persons carry on these activities with a level of independence appropriate to the size and activities of the management

company and the group it belongs, and the degree of risk to interests of the UCITS or other clients or to interests of investors.

21. All the procedures and measures indicated as examples in Article 22(3) of the MiFID Implementing Directive may be considered and applied in the sphere of UCITS management (including Chinese walls, separate supervision, remuneration safeguards etc).

22. Moreover, where these measures will not achieve the required objective, the management company should put in place alternative or additional measures which will ensure the necessary degree of independence.

Records of collective portfolio management activities

Level 2 advice

Box 15

Record of collective portfolio management or activities giving rise to detrimental conflict of interest

1. Management companies should keep and regularly update a record of the kinds of collective portfolio management activities carried out by or on behalf of the management company in which a conflict of interest entailing a material risk of damage to the interests of one or more UCITS or other clients, or investors in case of direct distribution, has arisen or, in the case of an ongoing collective portfolio management activity, may arise.

Explanatory text

23. Consistently with Article 23 of the MiFID L2 Directive, management companies should also be required to keep and regularly to update a record of the kinds of collective portfolio management activity carried out by or on behalf of the company in which a conflict of interest entailing a material risk of damage to the interests of one or more clients, or investors in case of direct distribution, has arisen or, in the case of an ongoing collective portfolio management activity, may arise.

Management of non-neutralised conflicts

Level 2 advice

Box 16

Management of non-neutralised conflicts

1. Where the organisational or administrative arrangements made by the management company to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of UCITS or of its unitholders will be prevented, the senior management or other competent internal body of the management company should be promptly informed in order for them to undertake any necessary decisions to ensure that in any case the management company acts in the best interests of the UCITS and of its unitholders.

The relevant UCITS should report those situations to investors by any appropriate durable medium and explain the decision taken by the management company.

2. In case of direct distribution of UCITS to investors, where the organisational or administrative arrangements made by the management company to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of investors will be prevented, the management company should clearly disclose by any appropriate durable medium the general nature and/or sources of conflicts of interest to the relevant investor before distributing the UCITS units.

Explanatory text

24. In CESR's view, a certain MiFID obligation concerning conflicts of interest merits deeper analysis. The requirement in question is the duty to disclose non-neutralised conflicts to clients or investors in line with Article 18(2) of the MiFID and Article 22(4) of the MiFID L2 Directive. CESR notes that the rule does not apply to management companies authorised to carry out the service of individual portfolio management[17].

25. Two situations must be distinguished in this context: the risks of damage to the interests of UCITS (and UCITS unitholders) and the risk of damage to the interests of investors when the management company directly distributes units of UCITS to those investors.

26. Regarding the first situation, considering the stronger separation between ownership and control in the sphere of collective portfolio management activities (where the unitholders cannot undertake their own investment decision) and the lack of sophistication of many UCITS unitholders, ex ante disclosure to unitholders may not be the most appropriate investor protection tool in connection with non-neutralised conflicts of interest. Therefore, CESR considers it appropriate to propose an alternative method for the management of non-neutralised conflicts of interest.

27. In particular, CESR advises that where organisational or administrative arrangements made by the management company to manage the conflicts are not sufficient to ensure, with reasonable confidence, that the risks of damage to the UCITS' interests will be prevented, the senior management or the other competent internal body of the management company should be promptly informed in order for them to take any necessary decisions to ensure fair treatment of the UCITS and its unitholders i.e. that the management company acts in all cases in the best interests of the UCITS and its unitholders.

[17] As mentioned, according to Article 6(4) of the compromise text of the UCITS Directive, the provision of the service of individual portfolio management by the management companies is subject to Articles 2(2), 12, 13 and 19 of MiFID.

28. It is understood that this solution should be without prejudice to the duty of management companies and the UCITS to report on the situations where the organisational or administrative arrangements for conflicts of interest were not sufficient to ensure, with reasonable confidence, the prevention of the risk of damage, for instance in their periodic reports. This reporting should explain and justify the decision taken by the management company (which can be a decision not to act) taking into account the internal policy and procedures adopted to identify, prevent and manage conflicts of interest.

29. Regarding the second situation, the same approach as the one foreseen in the MiFID should apply: where the organisational or administrative arrangements made by the management company to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of investors will be prevented, the management company should clearly disclose the general nature and/or sources of conflicts of interest to the relevant investor before he buys units of a UCITS sold by the management company.

30. In all situations, the report must be made in a durable medium and should include sufficient detail to enable the UCITS or the investor in the case of direct distribution to take an informed decision with respect to the activity or service in the context of which the conflict of interest arises. A durable medium for this purpose can include a website or the periodic reports of the UCITS.

31. Although Article 18 of the MiFID is not applicable to ancillary services, such as individual portfolio management or investment advice, provided by a management company[18], CESR recommends nonetheless that for the management of non-neutralised conflicts arising in the context of these services, the same approach is followed at national level as the one it proposes in this Advice for the management of non-neutralised conflicts arising in the context of collective portfolio management.

[18] See footnote 17.

ANNEX 1

Excerpt from MiFID L2 Directive 2006/73/EC on organisational requirements and internal control mechanisms

Article 5
(Article 13(2) to (8) of Directive 2004/39/EC)

General organisational requirements

1. Member States shall require investment firms to comply with the following requirements:

(a) to establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities;

(b) to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;

(c) to establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the investment firm;

(d) to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them;

(e) to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the investment firm;

(f) to maintain adequate and orderly records of their business and internal organisation;

(g) to ensure that the performance of multiple functions by their relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly, and professionally. Member States shall ensure that, for those purposes, investment firms take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.

2. Member States shall require investment firms to establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.

3. Member States shall require investment firms to establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of investment services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their investment services and activities.

4. Member States shall require investment firms to establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules.

5. Member States shall require investment firms to monitor and, on a regular basis, to evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements

established in accordance with paragraphs 1 to 4, and to take appropriate measures to address any deficiencies.

Article 6
(Article 13(2) of Directive 2004/39/EC)

Compliance

1. Member States shall ensure that investment firms establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under Directive 2004/39/EC, as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise their powers effectively under that Directive.

Member States shall ensure that, for those purposes, investment firms take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.

2. Member States shall require investment firms to establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:

(a) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures and procedures put in place in accordance with the first subparagraph of paragraph 1, and the actions taken to address any deficiencies in the firm's compliance with its obligations;

(b) to advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under Directive 2004/39/EC.

3. In order to enable the compliance function to discharge its responsibilities properly and independently, Member States shall require investment firms to ensure that the following conditions are satisfied:

(a) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;
(b) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting as to compliance required by Article 9(2);
(c) the relevant persons involved in the compliance function must not be involved in the performance of services or activities they monitor;
(d) the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

However, an investment firm shall not be required to comply with point (c) or point (d) if it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of investment services and activities, the requirement under that point is not proportionate and that its compliance function continues to be effective.

Article 8
(second subparagraph of Article 13(5) of Directive 2004/39/EC)

Internal audit

Member States shall require investment firms, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of investment services and activities undertaken in the course of that business, to establish and maintain an internal audit function which is separate and independent from the other functions and activities of the investment firm and which has the following responsibilities:

(a) to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the investment firm's systems, internal control mechanisms and arrangements;

(b) to issue recommendations based on the result of work carried out in accordance with point (a);

(c) to verify compliance with those recommendations;

(d) to report in relation to internal audit matters in accordance with Article 9(2).

Article 9
(Article 13(2) of Directive 2004/39/EC)

Responsibility of senior management

1. Member States shall require investment firms, when allocating functions internally, to ensure that senior management, and, where appropriate, the supervisory function, are responsible for ensuring that the firm complies with its obligations under Directive 2004/39/EC.

In particular, senior management and, where appropriate, the supervisory function shall be required to assess and periodically to review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations under Directive 2004/39/EC and to take appropriate measures to address any deficiencies.

2. Member States shall require investment firms to ensure that their senior management receive on a frequent basis, and at least annually, written reports on the matters covered by Articles 6, 7 and 8 indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies.

3. Member States shall require investment firms to ensure that the supervisory function, if any, receives on a regular basis written reports on the same matters.

4. For the purposes of this Article, 'supervisory function' means the function within an investment firm responsible for the supervision of its senior management.

Article 10
(Article 13(2) of Directive 2004/39/EC)

Complaints handling

Member States shall require investment firms to establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from retail clients or potential retail clients, and to keep a record of each complaint and the measures taken for its resolution.

Article 11
(Article 13(2) of Directive 2004/39/EC)

Meaning of personal transaction

For the purposes of Article 12 and Article 25, personal transaction means a trade in a financial instrument effected by or on behalf of a relevant person[19], where at least one of the following criteria are met:

(a) that relevant person is acting outside the scope of the activities he carries out in that capacity;

(b) the trade is carried out for the account of any of the following persons:
(i) the relevant person;
(ii) any person with whom he has a family relationship, or with whom he has close links;
(iii) a person whose relationship with the relevant person is such that the relevant person has a direct or indirect material interest in the outcome of the trade, other than a fee or commission for the execution of the trade.

Article 12
(Article 13(2) of Directive 2004/39/EC)

Personal transactions

1. Member States shall require investment firms to establish, implement and maintain adequate arrangements aimed at preventing the following activities in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 1(1) of Directive 2003/6/EC or to other confidential information relating to clients or transactions with or for clients by virtue of an activity carried out by him on behalf of the firm:

(a) entering into a personal transaction which meets at least one of the following criteria:
(i) that person is prohibited from entering into it under Directive 2003/6/EC;
(ii) it involves the misuse or improper disclosure of that confidential information;
(iii) it conflicts or is likely to conflict with an obligation of the investment firm under Directive 2004/39/EC;

(b) advising or procuring, other than in the proper course of his employment or contract for services, any other person to enter into a transaction in financial instruments which, if a personal transaction of the relevant person, would be covered by point (a) or Article 25(2)(a) or (b) or Article 47(3);

(c) without prejudice to Article 3(a) of Directive 2003/6/EC, disclosing, other than in the normal course of his employment or contract for services, any information or opinion to any other person if the relevant person knows, or reasonably ought to know, that as a result of that disclosure that other person will or would be likely to take either of the following steps:
(i) to enter into a transaction in financial instruments which, if a personal transaction of the relevant person, would be covered by point (a) or Article 25(2)(a) or (b) or Article 47(3);
(ii) to advise or procure another person to enter into such a transaction.

2. The arrangements required under paragraph 1 must in particular be designed to ensure that:

[19] According to the definition in Article (3) of the MiFID L2 Directive, *'relevant person' in relation to an investment firm, means any of the following: (a) a director, partner or equivalent, manager or tied agent of the firm; (b) a director, partner or equivalent, or manager of any tied agent of the firm; (c) an employee of the firm or of a tied agent of the firm, as well as any other natural person whose services are placed at the disposal and under the control of the firm or a tied agent of the firm and who is involved in the provision by the firm of investment services and activities; (d) a natural person who is directly involved in the provision of services to the investment firm or to its tied agent under an outsourcing arrangement for the purpose of the provision by the firm of investment services and activities*.

(a) each relevant person covered by paragraph 1 is aware of the restrictions on personal transactions, and of the measures established by the investment firm in connection with personal transactions and disclosure, in accordance with paragraph 1;

(b) the firm is informed promptly of any personal transaction entered into by a relevant person, either by notification of that transaction or by other procedures enabling the firm to identify such transactions;

In the case of outsourcing arrangements the investment firm must ensure that the firm to which the activity is outsourced maintains a record of personal transactions entered into by any relevant person and provides that information to the investment firm promptly on request.

(c) a record is kept of the personal transaction notified to the firm or identified by it, including any authorisation or prohibition in connection with such a transaction.

3. Paragraphs 1 and 2 shall not apply to the following kinds of personal transaction:

(a) personal transactions effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed;

(b) personal transactions in units in collective undertakings that comply with the conditions necessary to enjoy the rights conferred by Directive 85/611/EEC or are subject to supervision under the law of a Member State which requires an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected are not involved in the management of that undertaking.

ANNEX 2

Excerpt from MiFID L2 Directive 2006/73/EC on recordkeeping requirements

Article 51
(Article 13(6) of Directive 2004/39/EC)

Retention of records

1. Member States shall require investment firms to retain all the records required under Directive 2004/39/EC and its implementing measures for a period of at least five years.

Additionally, records which set out the respective rights and obligations of the investment firm and the client under an agreement to provide services, or the terms on which the firm provides services to the client, shall be retained for at least the duration of the relationship with the client.

However, competent authorities may, in exceptional circumstances, require investment firms to retain any or all of those records for such longer period as is justified by the nature of the instrument or transaction, if that is necessary to enable the authority to exercise its supervisory functions under Directive 2004/39/EC.

Following the termination of the authorisation of an investment firm, Member States or competent authorities may require the firm to retain records for the outstanding term of the five year period required under the first subparagraph.

2. The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the competent authority, and in such a form and manner that the following conditions are met:

(a) the competent authority must be able to access them readily and to reconstitute each key stage of the processing of each transaction;

(b) it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained;

(c) it must not be possible for the records otherwise to be manipulated or altered.

3. The competent authority of each Member State shall draw up and maintain a list of the minimum records investment firms are required to keep under Directive 2004/39/EC and its implementing measures.

4. Record-keeping obligations under Directive 2004/39/EC and in this Directive are without prejudice to the right of Member States to impose obligations on investment firms relating to the recording of telephone conversations or electronic communications involving client orders.

5. Before 31 December 2009 the Commission shall, in the light of discussions with the Committee of European Securities Regulators, report to the European Parliament and the Council on the continued appropriateness of the provisions of paragraph 4.

Excerpt from MiFID L2 Regulation No. 1287/2006 on recordkeeping requirements

Article 7
(Article 13(6) of Directive 2004/39/EC)

Record-keeping of client orders and decisions to deal

An investment firm shall, in relation to every order received from a client, and in relation to every decision to deal taken in providing the service of portfolio management, immediately make a record of the following details, to the extent they are applicable to the order or decision to deal in question:

(a) the name or other designation of the client;

(b) the name or other designation of any relevant person acting on behalf of the client;

(c) the details specified in points 4, 6 and 16 to 19, of Table 1 of Annex I;

(d) the nature of the order if other than buy or sell;

(e) the type of the order;

(f) any other details, conditions and particular instructions from the client that specify how the order must be carried out;

(g) the date and exact time of the receipt of the order, or of the decision to deal, by the investment firm.

Article 8
(Article 13(6) of Directive 2004/39/EC)

Record-keeping of transactions

1. Immediately after executing a client order, or, in the case of investment firms that transmit orders to another person for execution, immediately after receiving confirmation that an order has been executed, investment firms shall record the following details of the transaction in question:

(a) the name or other designation of the client;

(b) the details specified in points 2, 3, 4, 6 and 16 to 21, of Table 1 of Annex I;

(c) the total price, being the product of the unit price and the quantity;

(d) the nature of the transaction if other than buy or sell;
(e) the natural person who executed the transaction or who is responsible for the execution.

2. If an investment firm transmits an order to another person for execution, the investment firm shall immediately record the following details after making the transmission:

(a) the name or other designation of the client whose order has been transmitted;

(b) the name or other designation of the person to whom the order was transmitted;

(c) the terms of the order transmitted;

(d) the date and exact time of transmission.

Annex I of the MiFID L2 Regulation

Table 1

List of fields for reporting purposes

Field Identifier	Description
1. Reporting firm identification	A unique code to identify the firm which executed the transaction.
2. Trading day	The trading day on which the transaction was executed.
3. Trading time	The time at which the transaction was executed, reported in the local time of the competent authority to which the transaction will be reported, and the basis in which the transaction is reported expressed as Coordinated Universal Time (UTC) +/- hours.
4. Buy/sell indicator	Identifies whether the transaction was a buy or sell from the perspective of the reporting investment firm or, in the case of a report to a client, of the client.
5. Trading capacity	Identifies whether the firm executed the transaction: — on its own account (either on its own behalf or on behalf of a client), — for the account, and on behalf, of a client.
6. Instrument identification	This shall consist of: — a unique code, to be decided by the competent authority (if any) to which the report is made identifying the financial instrument which is the subject of the transaction, — if the financial instrument in question does not have a unique identification code, the report must include the name of the instrument or, in the case of a derivative contract, the characteristics of the contract.
7. Instrument code type	The code type used to report the instrument.
8. Underlying instrument identification	The instrument identification applicable to the security that is the underlying asset in a derivative contract as well as the transferable security falling within Article 4(1)(18)(c) of Directive 2004/39/EC.
9. Underlying instrument identification code type	The code type used to report the underlying instrument.
10. Instrument type	The harmonised classification of the financial instrument that is the subject of the transaction. The description must at least indicate whether the instrument belongs to one of the top level categories as provided by a uniform internationally accepted standard for financial instrument classification.
11. Maturity date	The maturity date of a bond or other form of securitised debt, or the exercise date/maturity date of a derivative contract.
12. Derivative type	The harmonised description of the derivative type should be done

	according to one of the top level categories as provided by a uniform internationally accepted standard for financial instrument classification.
13. Put/call	Specification whether an option or any other financial instrument is a put or a call.
14. Strike price	The strike price of an option or other financial instrument.
15. Price multiplier	The number of units of the financial instrument in question which are contained in a trading lot; for example, the number of derivatives or securities represented by one contract.
16. Unit price	The price per security or derivative contract excluding commission and (where relevant) accrued interest. In the case of a debt instrument, the price may be expressed either in terms of currency or as a percentage.
17. Price notation	The currency in which the price is expressed. If, in the case of a bond or other form of securitised debt, the price is expressed as a percentage, that percentage shall be included.
18. Quantity	The number of units of the financial instruments, the nominal value of bonds, or the number of derivative contracts included in the transaction.
19. Quantity notation	An indication as to whether the quantity is the number of units of financial instruments, the nominal value of bonds or the number of derivative contracts.
20. Counterparty	Identification of the counterparty to the transaction. That identification shall consist of: — where the counterparty is an investment firm, a unique code for that firm, to be determined by the competent authority (if any) to which the report is made, — where the counterparty is a regulated market or MTF or an entity acting as its central counterparty, the unique harmonised identification code for that market, MTF or entity acting as central counterparty, as specified in the list published by the competent authority of the home Member State of that entity in accordance with Article 13(2), — where the counterparty is not an investment firm, a regulated market, an MTF or an entity acting as central counterparty, it should be identified as 'customer/client' of the investment firm which executed the transaction.
21. Venue identification	Identification of the venue where the transaction was executed. That identification shall consist in: — where the venue is a trading venue: its unique harmonised identification code, — otherwise: the code 'OTC'.
22. Transaction reference	A unique identification number for the transaction provided by the

number	investment firm or a third party reporting on its behalf.
23. Cancellation flag	An indication as to whether the transaction was cancelled.

ANNEX 3

Excerpt from MiFID L2 Directive 2006/73/EC on conflicts of interests

Article 21
(Articles 13(3) and 18 of Directive 2004/39/EC)

Conflicts of interest potentially detrimental to a client

Member States shall ensure that, for the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, investment firms take into account, by way of minimum criteria, the question of whether the investment firm or a relevant person, or a person directly or indirectly linked by control to the firm, is in any of the following situations, whether as a result of providing investment or ancillary services or investment activities or otherwise:

(a) the firm or that person is likely to make a financial gain, or avoid a financial loss, at the expense of the client;

(b) the firm or that person has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;

(c) the firm or that person has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;

(d) the firm or that person carries on the same business as the client;

(e) the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.

Article 22
(Articles 13(3) and 18(1) of Directive 2004/39/EC)

Conflicts of interest policy

1. Member States shall require investment firms to establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business. Where the firm is a member of a group, the policy must also take into account any circumstances, of which the firm is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group.

2. The conflicts of interest policy established in accordance with paragraph 1 shall include the following content:

(a) it must identify, with reference to the specific investment services and activities and ancillary services carried out by or on behalf of the investment firm, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients;

(b) it must specify procedures to be followed and measures to be adopted in order to manage such conflicts.

3. Member States shall ensure that the procedures and measures provided for in paragraph 2(b) are designed to ensure that relevant persons engaged in different business activities involving a conflict of interest of the kind specified in paragraph 2(a) carry on those activities at a level of independence appropriate to the size and activities of the investment firm and of the group to which it belongs, and to the materiality of the risk of damage to the interests of clients.

For the purposes of paragraph 2(b), the procedures to be followed and measures to be adopted shall include such of the following as are necessary and appropriate for the firm to ensure the requisite degree of independence:

(a) effective procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients;

(b) the separate supervision of relevant persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the firm;

(c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;

(d) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out investment or ancillary services or activities;

(e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate investment or ancillary services or activities where such involvement may impair the proper management of conflicts of interest.

If the adoption or the practice of one or more of those measures and procedures does not ensure the requisite degree of independence, Member States shall require investment firms to adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes.

4. Member States shall ensure that disclosure to clients, pursuant to Article 18(2) of Directive 2004/39/EC, is made in a durable medium and includes sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the investment or ancillary service in the context of which the conflict of interest arises.

Article 23
(Article 13(6) of Directive 2004/39/EC)

Record of services or activities giving rise to detrimental conflict of interest

Member States shall require investment firms to keep and regularly to update a record of the kinds of investment or ancillary service or investment activity carried out by or on behalf of the firm in which a conflict of interest entailing a material risk of damage to the interests of one or more clients has arisen or, in the case of an ongoing service or activity, may arise.

Section II
CESR's technical advice on possible implementing measures of Article 14(2)(b) of the UCITS Directive
(Rules of conduct for management companies)

INTRODUCTION

1. The Commission's mandate requested CESR to advise, inter alia, on the criteria according to which the conduct of its business by a management company should be assessed by the competent authorities (according to Article 14(2)(b) of the UCITS Directive). CESR was requested to deliver its technical advice in form of an 'articulated' text by 30 October 2009 at the latest.

2. The present advice has been prepared taking due account of the overarching principle of high level of investor protection and supervision, also in the light of the recent developments in the financial markets. The principle of proportionality has also been taken into account, with a view to avoid creating excessive administrative or procedural burdens either on UCITS/management companies or the relevant competent authorities. In addition, the principles laid down in this paper should be considered having in mind that a UCITS may be constituted under different forms (such as an investment company or a contractual fund) and, therefore, adjusted where applicable to the form of the UCITS.

3. In line with the directions given by the Commission in the mandate, the present advice seeks as much consistency as possible with the MiFID regime, taking due account of the specificities of the collective management business.

4. It should be noted that management companies performing the service of individual portfolio management are already subject to MiFID-related provisions and, before the introduction of MiFID, to the ISD.

5. Article 6(4) of the UCITS Directive – which confirms Article 5(4) of the previous version of the Directive – states that Articles 2(2), 12, 13 and 19 of MiFID apply to the provision of the service of individual portfolio management by management companies.

6. Article 1(2) of the MiFID L2 Directive provides that the following rules of that Directive apply to management companies performing the service of individual portfolio management:

   - Chapter II (Organisational requirements);
   - Sections 1 to 4 (Inducements; Information to clients and potential clients; Assessment of suitability and appropriateness; Reporting to clients), Article 45 (Duty of investment firms carrying out portfolio management and reception and transmission of orders to act in the best interests of the client) and Section 6 (Client order handling) and 8 (Record-keeping) of Chapter III (Operating conditions for investment firms).

7. CESR is of the view that it would be burdensome and inconsistent to require management companies to comply with different regimes with respect to individual and collective portfolio management. It is therefore proposed that MiFID-like conduct of business rules should apply, with the necessary adjustments, to the business of collective portfolio management as detailed below.

8. In addition, taking into account the peculiarities of the UCITS area and the lessons learned from the current financial crisis, CESR proposes that specific requirements be introduced regarding the due diligence that management companies are expected to carry out in the selection of investments.

9. CESR considers that investment companies should not be treated differently from management companies for the purposes of the rules of conduct to be complied with in the activity of collective portfolio management. Therefore, and without prejudice to the responsibility of the board of directors of investment companies having designated a management company, this advice should

apply to both management companies and investment companies that do not have a designated management company (self-managed UCITS), taking into account the principle of proportionality. Any reference in this part of the consultation paper to management companies should accordingly be read also as a reference to such investment companies.

10. CESR acknowledges that, as far as allowed by national law, management companies may make arrangements for third parties to carry out some of their activities. This advice must be read accordingly. The management company will in particular perform a due diligence in order to determine whether, having regard to the nature of the functions to be carried out by third parties, the undertaking performing those activities can be considered as qualified and capable of undertaking the functions in question. This implies that the third party will have to fulfil all the conduct of business rules pertaining to the activity to be carried out. It also entails that the management company will have to verify that the third party has taken the appropriate measures in order to comply with the said rules and will have to monitor effectively the compliance by the third party with these rules. This implies, in the field of the delegated activities, where the delegatee applies effectively the rules governing the delegated activities, that the relevant rules of conduct requirements will apply, mutatis mutandis, to the activity of monitoring of the delegated activities.. The management company may take into account in the due diligence process the fact that the third party to whom activities are delegated is submitted itself to MiFID. This advice must be construed consistently with the principle that in no case shall the management company's or the depositary's liability be affected by the fact that the management company makes arrangements for third parties to carry out certain activities; nor shall the management company make such arrangements to the extent that it becomes a letter-box entity. The arrangements with third parties may never be used to circumvent the provisions of the UCITS Directive, including the requirements on conduct of business rules.

11. Direct distribution of both units of UCITS managed by the management company itself and managed by other management companies is a permissible activity of UCITS management companies as set out by Recital 12 of the Directive. CESR considers, therefore, that the activity of direct selling should be subject to regulatory requirements as it raises regulatory concerns, and that the application of MiFID standards to this activity would ensure a level playing field with intermediated sales. However, CESR recognises that the work carried out by the European Commission as set out in its communication of 29 April 2009 on Packaged Retail Investment Products (PRIPs)[20] will address the issue of direct selling, as well as disclosure to investors, with a view to ensuring a consistent approach to the retail distribution of substitute investment products, improving investor protection and addressing level playing field issues.

12. In line with the mandate, this part of the advice deals only with the provision of collective portfolio management by management companies to UCITS (leaving out of the scope the provision of services to non-UCITS managed by UCITS management companies). Nonetheless, CESR recommends that the same approach, where relevant, is followed at national level for non-UCITS managed by UCITS management companies.

Impact on firms

13. As stated in paragraph 7, CESR considers it would be burdensome and inconsistent to require management companies to comply with different rules of conduct regimes in respect to individual and collective portfolio management.

14. However, CESR is mindful about the potential impacts of applying rule of conduct requirements similar to MiFID requirements to the collective portfolio management business of UCITS management companies.

[20] http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_communication_en.pdf

15. The actual impact of implementing the proposals described in this paper depends on how much this will change the internal policies and behaviour of UCITS management companies. This depends on whether management companies already apply the proposed rules or whether on a national level there is already a degree of read-across of MiFID provisions to the collective portfolio management business of UCITS management companies.

16. In order to get a full picture about this situation, CESR carried out a survey among its members to establish the extent of read-across of MiFID provisions to the collective portfolio management business of UCITS management companies. The survey has shown a significant variation in regulatory practices across CESR member states. On one end of the scale, several Member States have a near complete read-across of MiFID provisions on rules of conduct for the collective portfolio management business of UCITS management companies. On the other end of the scale, there are a few Member States where there is basically no read-across, with regulatory practices of many CESR Members between these boundaries.

17. As the current regulatory situation varies across the member states, CESR was very much interested in the views of stakeholders about the impacts i.e. the costs and benefits, of the proposals on rules of conduct for UCITS management companies. The responses to the consultation were taken into account by CESR in providing its final advice to the Commission.

CONDUCT OF BUSINESS
(Article. 14(2)(b) of the UCITS Directive)

Extract from the level 1 text

Article 14(1)(a)(b)(e) - '1. Each Member State shall draw up rules of conduct wh

ich management companies authorised in that Member State shall observe at all times. Such rules shall implement at least the principles set out in points (a) to (e). Those principles shall ensure that a management company:

(a) acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market;

(b) acts with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market;

(e) complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its investors and the integrity of the market'.

Article 14(2)(b) - 'Without prejudice to Article 116, the Commission shall adopt, by 1st July 2010, implementing measures, with a view to ensuring that the management company complies with the duties set out in paragraph 1, in particular to:

(b) establish appropriate criteria for acting honestly and fairly and with due skill, care and diligence in the best interests of the UCITS'.

Extract from the Commission's mandate

CESR is invited to advise the Commission on the criteria according to which the conduct of its business by a management company should be assessed by the competent authorities (according to Article 14(2)(b)).

DEFINITIONS

'CIU' has the same meaning as 'collective investment undertaking' under the UCITS Directive and includes UCITS.

'Client' means any natural or legal person, or any other undertaking (including UCITS), to whom a management company provides activities of collective portfolio management or services in the meaning of Article 6, paragraph 3 of the UCITS Directive.

'Collective portfolio management' means one or more of the functions pertaining to the activity of collective portfolio management as defined under Annex II of the UCITS Directive.

'Delegation' means delegation of functions to third parties by a management company pursuant to Article 13 of the UCITS Directive.

'Durable medium' should mean any instrument which enables an investor to store information addressed personally to that investor in a way accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored.

'Execution venue' means, in the sense of the MiFID, a regulated market, an MTF, a systematic internaliser, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

'Investor' means any unitholder or potential unitholder.

'UCITS Directive' means the Directive on undertakings for collective investment in transferable securities adopted by the Council on 22 June 2009, following a first-reading agreement with the European Parliament (position of the European Parliament adopted on 13 January 2009).

'MiFID' means Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments.

'MiFID L2 Directive' or 'MiFID implementing Directive' means the Commission's Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms.

'MiFID L2 Regulation' means the Commission's Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

'The mandate' means the European Commission's *Provisional Request to CESR for Technical Advice on Possible Implementing Measures Concerning the Future UCITS Directive*, February 13, 2009.

'Professional investor' means an investor that would be categorized as a professional client under MiFID.

'Retail investor' means an investor that would be categorized as a retail client under MiFID.

'Relevant person' in relation to a management company, means any of the following:
(a) a director, partner or equivalent, or manager of the management company;

(b) an employee of the management company, as well as any other natural person whose services are placed at the disposal and under the control of the management company and who is involved in the provision by the management company of collective portfolio management
(c) a natural person who is directly involved in the provision of services to the management company under a delegation arrangement for the purpose of the provision by the management company of collective portfolio management.

'Senior management' means the persons who effectively direct the business of a management company according to Article 7.1(b) of the UCITS Directive[21].

'UCITS' has the same meaning as UCITS in the UCITS Directive.

'Unitholder' means any natural or legal person holding one or more units in a UCITS.

[21] The persons vested with the role of senior management may vary depending on the provisions of company law in force in each Member State and may thus be the entire board.

B. Provision of the service of collective portfolio management

Box 1

Duty to act in the best interests of the UCITS and its unitholders and to ensure market integrity

1. Management companies should ensure that unitholders of managed UCITS are treated fairly and should refrain from undue preferences of one group of unitholders over others.

2. Management companies should apply appropriate policies and procedures reasonably designed to prevent late trading, market timing and other malpractices liable to affect the stability and the integrity of the market.

3. Without prejudice to specific national law requirements, management companies should ensure that fair, correct and transparent pricing models and valuation systems are applied for the UCITS they manage, in order to comply with the duty to act in the best interests of the unitholders. Management companies should be able to demonstrate that the UCITS portfolios have been accurately valued.

4. Management companies should act in a way to prevent undue costs being charged to the UCITS and unit-holders and should avoid churning in the management of their portfolios.

1. As acknowledged by IOSCO (Best Practices Standards on Anti Market Timing and Associated Issues for CIS, October 2005), certain behaviours, such as market timing and late trading, might have detrimental effects on unitholders and undermine the proper functioning and confidence in the market. Management companies should treat unitholders fairly and should not favour one group of unitholders (such as, for instance, market timers) over others (for example long term unitholders or unitholders of one investment compartment over another). Accordingly, it is proposed that management companies be expected to take appropriate measures to monitor, detect and deter potential market timing and late trading practices for each UCITS they manage.

2. Management companies should be able to demonstrate to the competent authorities that the UCITS portfolios have been accurately valued. In addition, according to Article 14(1)(e) of the UCITS Directive, the management company shall comply with conduct of business requirements so as to promote the best interests of its investors and the integrity of the market. As highlighted in the relevant IOSCO standards (see Final Report On Elements Of International Regulatory Standards On Fees And Expenses Of Investment Funds, November 2004), which management companies are expected to comply with, management companies are bound by fiduciary duties towards the unitholders of the funds they manage. On this basis, management companies should apply clear criteria and transparency as regards the definition of the fees and expenses for the UCITS they manage.

3. Management companies should be able to prevent undue costs and burdens being placed on the UCITS. Management companies should put in place appropriate procedures to guard against unreasonable charges and excessive trading, taking into account the UCITS' investment objectives and policy.

B.2 Due diligence requirements

Box 2

1. Management companies should ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of the investors and the integrity of the market.

2. Management companies should ensure they have adequate knowledge and understanding of the assets in which the UCITS are invested and ensure that UCITS are only invested in financial assets whose risks can be adequately assessed, monitored and managed by the risk management process adopted by the company.

3. Management companies should establish written due diligence policies and procedures and implement effective arrangements for ensuring that investment decisions on behalf of the UCITS are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS.

4. Before carrying out investments, management companies shall, where appropriate taking into account the nature of the foreseen investment, formulate forecasts and perform analyses concerning its contribution to the UCITS' portfolio composition, liquidity and risk and reward profile. These analyses should be supported by reliable, updated and meaningful information, both in quantitative and qualitative terms.

Explanatory text

4. Management companies are responsible and accountable for investment decisions carried out on behalf of the UCITS. Management companies should therefore adopt written due diligence policies and procedures as well as an investment process where the general indications concerning the investment strategies of the UCITS are subsequently transposed into coherent and appropriate investment decisions.

5. Management companies should ensure a high level of diligence in the selection and ongoing monitoring of investments and should therefore have the appropriate professional expertise and analytical and research capacities. This also implies that management companies should ensure that UCITS are only invested in financial assets whose risks can be adequately assessed, monitored and managed by the risk management process adopted by the company.

6. Management companies should carry out appropriate technical due diligence prior to arranging for execution. They should acquire adequate knowledge and understanding of the financial instruments and assets in which the portfolio of the UCITS is intended to be invested and all the information necessary to formulate, where appropriate taking into account the foreseen investment, forecasts and perform analysis regarding the expected portfolio composition and risk reward profile (portfolio optimisation process).

7. The due diligence policies and procedures should be proportionate to the complexity and level of risk of the financial instruments and the types of asset in which the UCITS can be invested.

8. Different factors could be relevant in the due diligence process. The management company should make an overall assessment of at least:

   - the eligibility of the particular investment in accordance with the parameters set in Directive 2007/16/EC and accompanying CESR Guidelines;
   - the consistency of the particular investment with the UCITS' risk profiles, investment strategy and objectives;

- the compliance of the particular investment decision with the conflicts of interest rules;
- the compatibility of the particular investment with the obligations on NAV calculation and publication;
- the liquidity of the particular investment, so as to ensure that the UCITS can meet redemptions at the request of unitholders;
- any additional criteria that the management company feels relevant in the best interests of the UCITS and the integrity of the market;
- in case of funds of funds, the underlying funds and their relevant depository arrangements.

9. Due diligence should be conducted before carrying out the investments on behalf of the UCITS and subsequently on a periodic basis, in order to ensure that the investment remains adequate in the best interests of the UCITS and the integrity of the market. Due diligence should be carried out according to the principles set out in CESR's Risk Management Principles for UCITS and, in any case, by operational units that function independently from those that undertake investment decisions. Management companies should maintain documented evidence concerning the performance of UCITS portfolio management, of its consistency with the investment strategies defined for each UCITS, and of the analyses and forecasts which underpinned these strategies.

10. Along with the definition of general due diligence requirements, management companies should carry out additional analysis for the selection and monitoring of certain more complex investments, such as target underlying funds or complex and / or structured products whose features may raise particular concerns in terms of operational, legal and liquidity risks. In this respect, management companies should, inter alia, verify the legal documentation (fund rules, prospectus etc.) of the underlying funds, their valuation procedures, the dissemination of information, the conditions for subscriptions and redemptions, the fees and expenses, the 'quality' of the fund manager and of the service providers or counterparties. In accordance with CESR's guidelines concerning eligible assets for investment by UCITS, the management company should also be expected to verify that there are independent custody arrangements and robust governance structures for the underlying CIU.

11. Management companies should in practice be able to justify their assessment. For this purpose, they could be requested to define appropriate procedures, which might include a checklist of the criteria to be considered in the due diligence, and keep a record of their assessment. Procedures should be regularly reviewed to ensure that that they remain appropriate.

12. Competent authorities should pay attention to the due diligence process and procedures adopted by the management companies during their investigations.

C. Direct Distribution

Level 2 advice

Box 3

Management companies shall, in case of direct distribution of UCITS to investors, act honestly, fairly and professionally in accordance with the best interest of the investor and comply, in particular, with the principles set out in boxes 4 to 11.

13. Recital 7 of Directive 107/2001 states:

    'With regard to collective portfolio management (management of unit trusts/common funds and investment companies), the authorisation granted to a management company authorised in its home Member State should permit the company to carry on in host Member States the following activities: to distribute the units of the harmonised unit trusts/common funds managed by the company in its home Member State; to distribute the shares of the harmonised investment companies, managed by such a company; ….'.

14. Recital 12 of the UCITS Directive states:

    'With regard to collective portfolio management (management of unit trusts/common funds and investment companies), the authorisation granted to a management company authorised in its home Member State should permit the company to carry on in host Member States the following activities without prejudice to Chapter XI: to distribute through a branch the units of the harmonised unit trusts/common funds managed by this company in its home Member State; to distribute the shares of the harmonised investment companies, managed by such a company, through the establishment of a branch; to distribute the units of the harmonised unit trusts/common funds or shares of the harmonised investment companies managed by other management companies; … When a management company distributes the units of its own harmonised unit trusts/common funds or shares of its own harmonised investment companies in host Member States, without the establishment of a branch, it should only be subject to rules regarding cross-border marketing'.

15. It is therefore acknowledged that the authorisation as management company – more especially the collective portfolio management function of marketing – allows such companies to distribute the units of UCITS, either directly (hereafter referred to as 'direct distribution') or through an intermediary, without the need for an additional authorisation under MiFID. Direct distribution – which is thus a non-intermediated distribution of UCITS – is an activity that can be provided either at the initiative of an investor or by the management company without such an initiative of an investor. Direct distribution thus implies a direct relationship with the relevant investor.

16. In line with the overall approach of this Advice to the conduct of business rules for management companies, CESR considers that 'direct distribution' should be subject to conduct of business rules which are consistent with the relevant MiFID rules.

Box 4

Appropriateness test and execution only

1. Management companies should ask the investor to provide information regarding his knowledge and experience in the investment field relevant to the envisaged UCITS so as to enable the management company to assess whether this UCITS is appropriate for this investor.

2. When assessing whether the UCITS is appropriate for an investor, the management company should determine whether that investor has the necessary experience and knowledge in order to understand the risks involved in relation to the purchase of units of the concerned UCITS.

For those purposes, a management company shall be entitled to assume that a professional investor has the necessary experience and knowledge in order to understand the risks involved in relation to the envisaged UCITS.

3. The information regarding an investor's knowledge and experience in the investment field relevant to the concerned UCITS includes the following, to the extent appropriate to the nature of the investor and the type of UCITS envisaged, including their complexity and the risks involved:

(a) the types of financial instrument with which the investor is familiar;
(b) the nature, volume, and frequency of the investor's transactions in financial instruments and the period over which they have been carried out;
(c) the level of education, and profession or relevant former profession of the investor.

4. A management company shall not encourage an investor not to provide information referred to under paragraph 1.

5. A management company should be entitled to rely on the information provided by its investors unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete.

6. In case a management company considers, on the basis of the information received from the investor under paragraph 1, that the envisaged UCITS is not appropriate for the investor, the management company shall warn the investor. This warning may be provided in a standardised format.

7. In cases where the investor elects not to provide the information referred to under paragraph 1, or where he provides insufficient information regarding his knowledge and experience, the management company shall warn the investor that such a decision will not allow the management company to determine whether the envisaged UCITS is appropriate for him. This warning may be provided in a standardised format.

8. Management companies can receive subscription and redemption orders for UCITS units without the need to obtain the information or make the determination provided for in paragraphs 1 and 2 when all of the following conditions are met :

- the distribution of the relevant UCITS is provided at the initiative of the investor;
- the investor has been clearly informed that in the distribution of the relevant UCITS, the management company is not required to assess the appropriateness of the UCITS offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules; this warning could be provided in a standardised format;
- the management company complies with its obligations regarding conflicts of interest.

Box 5

Handling of subscription and redemption orders of investors

Management companies should handle and process subscription and redemption orders from investors in accordance with the relevant provisions of the fund rules or the instruments of incorporation and/of the prospectus.

Box 6

Reporting obligations in respect of execution of subscription and redemption orders

1. Where management companies carry out a subscription or redemption order from an investor, they should take the following action in respect of that order:

(a) the management company should promptly provide the investor, in a durable medium, with the essential information concerning the execution of that order;
(b) the management company should send the retail investor a notice, in a durable medium, confirming execution of the order as soon as possible, and no later than the first business day following execution or, if the confirmation is received by the management company from a third party, no later than the first business day following receipt of the confirmation from the third party.

Point (b) should not apply where the confirmation notice would contain the same information as a confirmation that is to be otherwise promptly dispatched to the investor by another person.

In the case of orders for an investor which are executed periodically, management companies either take the action specified in point (b) or provide the investor, at least once every six months, with the information listed in paragraph 3 in respect of those transactions.

2. In addition to the requirements under paragraph 1, management companies shall supply the investor, on request, with information about the status of his order.

3. The notice referred to in point (b) of paragraph 1 shall include such of the following information as is applicable:
(a) the management company identification;
(b) the name or other designation of the investor ;
(c) the date and time of receipt of the order and method of payment;
(d) the date of execution;
(e) the UCITS identification;
(f) the nature of the order (subscription or redemption);
(g) the number of units involved;
(h) the unit value at which the units were subscribed or redeemed, and the reference value date;
(i) the total amount;
(j) a total sum of the commissions and expenses charged and, where the investor so requests, an itemised breakdown;
(k) the investor's responsibilities in relation to the settlement of the transaction, including the time limit for payment or delivery as well as the appropriate account details, where these details and responsibilities have not previously been notified to the investor.

Explanatory text

17. CESR notes at the outset that according to Article 6(4) of the UCITS Directive, management companies proving investment advice are subject to Article 19 of MiFID and relevant implementing provisions, including the suitability test requirements. Therefore, whenever the direct distribution of UCITS is combined with provision of investment advice, Article 19 of MiFID must apply. Moreover, Member States may have chosen to apply the conduct of business rules of Article 19 of MiFID to management companies on the basis of provisions of national law.

18. Similarly, CESR considers that where a management company directly distributes the units of UCITS to investors, at their initiative or not, the management company should comply with Article 19 of MiFID and relevant MiFID level 2 provisions, including the assessment of appropriateness (Chapter III, Section 3 of the MiFID L2 Directive). Such an approach would ensure the level playing field between MiFID firms distributing UCITS and management companies performing the same activity.

19. CESR notes that the issues of direct distribution by management companies, regarding both the issue of selling practices and of the disclosure/information that a management company should provide to investors in connection with the direct distribution of UCITS, will be further explored by the Commission in its work on Packaged Retail Investment Products (PRIPs) as set out in its Communication of 29 April 2009.

20. Box 4, points 1 to 7, provides for all requirements concerning the appropriateness test that management companies should conduct before distributing a UCITS directly to an investor. These requirements are the same as or analogous to those of Articles 19(5) of the MiFID and 36 and 37 of the MiFID implementing Directive.

21. When applying the appropriateness test, the management company may take into account the category of the relevant investor (within the meaning of MiFID: retail or professional) and, in line with Article 36 of the MiFID L2 Directive, may assume that an investor that would, under MiFID, be categorised as a professional client, has the necessary experience and knowledge in order to understand the risks involved in relation to the purchase of units of the concerned UCITS. This proposal aims at striking a balance between addressing the level playing field issue in relation to intermediated sales and avoiding administrative burdens on management companies resulting from requirements of client categorisation, taking into account the nature of the products sold, namely UCITS which are considered to be a retail product.

22. Point 8 of Box 4 concerns the specific conditions under which an 'execution only' approach is possible along the line of Article 19(6) of MiFID.

23. The requirements regarding client order handling take into account the specificities of UCITS. They refer to the relevant provisions of the fund rules or articles of incorporation and of the prospectus (e.g. cut off time).

24. Box 6 concerns the reporting obligations of management companies in respect of execution of subscription and redemption orders. It reflects the requirements of Article 40 of the MiFID implementing Directive, amended as required in the context of UCITS.

D. Best execution

Direct execution of orders by the management company

Level 2 advice

Box 7

Duties of management companies to act in the best interests of the UCITS when executing the decisions to deal on behalf of the managed UCITS in the context of the management of their portfolios.

1. Management companies should act in the best interests of the UCITS they manage when executing the decisions to deal on behalf of the managed UCITS in the context of the management of their portfolios.

2. To this purpose, management companies should take all reasonable steps to obtain the best possible result for the UCITS taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of these factors should be determined by reference to the following criteria:
(a) the objectives, investment policy and risks specific to the UCITS, as indicated in the prospectus or as the case may be in the fund rules or articles of association of the UCITS;
(b) the characteristics of the order;
(c) the characteristics of financial instruments that are the subject of that order;
(d) the characteristics of the execution venues to which that order can be directed.

3. Management companies should establish and implement effective arrangements for complying with the obligation in paragraph 2. In particular management companies should establish and implement a policy to allow them to obtain, for the UCITS orders, the best possible result in accordance with paragraph 2. Management companies should obtain the prior consent of the UCITS on the execution policy and make available appropriate information to the unitholders on the policy established in accordance with this Box and on any material changes to their policy.

4. Management companies should monitor on a regular basis the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies.

5. Management companies should review annually their execution policy. Such review should also be carried out whenever a material change occurs that affects the management company's ability to continue to obtain the best possible result for the managed UCITS.

6. Management companies should be able to demonstrate to the relevant UCITS, that they have executed orders on behalf of the UCITS in accordance with the company's execution policy.

Explanatory text

25. Management companies may either directly execute orders on behalf of the UCITS or transmit such orders to other entities for execution, if necessary instructing them on how or where to execute. As a consequence, for the purposes of best execution, management companies present issues similar to those of other types of portfolio manager.

26. Indeed, management companies that provide the service of individual portfolio management must already comply with the MiFID best execution rules pursuant to Article 21 of MiFID and Articles 44 to 46 of the MiFID L2 Directive.

27. It seems therefore reasonable that unitholders benefit from protections similar to those afforded by the best execution requirements under MiFID.

28. When executing orders on behalf of the UCITS, management companies should be expected to take all reasonable steps to obtain the best possible result for the UCITS on a consistent basis, taking into account price, costs, speed, likelihood of execution and settlement, size and nature of the order or any other consideration relevant to the execution of the order.

29. The best execution requirements should not undermine the discretion of management companies in how they organise their business model and their execution arrangements. They should retain the flexibility to tailor their policy to the objectives, investment policy and risks specific to the UCITS they manage.

30. It is therefore proposed that the relative importance of the above-mentioned factors is not pre-determined, but established by the management companies in the specific context of their business according to criteria consistent with those set out in Article 44 of the MiFID L2 Directive, subject to the necessary adjustments.

31. The aforementioned principles should be complemented by the requirement for management companies to establish and implement effective organisational arrangements, and in particular an order execution policy which allows them to obtain the best possible result on a consistent basis.

32. In order to ensure that the policies (as well as the arrangements taken under such policies) remain appropriate, it is important to require management companies not to leave a gap of more than 12 months between each review of such policies and to adjust them (as well as the relevant arrangements) whenever a material change occurs. This would ensure consistency with MiFID requirements (see Article 21 of MiFID and Article 46 of the MiFID L2 Directive).

33. Unitholders should have access to appropriate information about the above-mentioned policy and material amendments thereof. Regarding the appropriateness of the information, reference could be made to Article 46(2) of the MiFID L2 Directive. It is the management company's responsibility to decide the medium through which such information is made accessible to unitholders. The medium chosen should be consistent with the medium usually used to provide information regarding the relevant UCITS and should enable the unitholders to relate the information to the relevant UCITS.

34. In line with Article 21(5) of MiFID, it is recommended that management companies be able to demonstrate to the relevant UCITS that they have executed their orders in accordance with their policy.

35. Due to the specificities of the business of collective portfolio management, the provisions in MiFID and the MiFID L2 Directive referring to specific instructions by the client are not considered to be relevant for the UCITS area (see Article 21(1) second sentence of MiFID; Article 44(2) and Article 46(2)(c) of the MiFID L2 Directive).

Placement of orders with other entities for execution

Level 2 advice

Box 8

Duties of management companies in the context of the management of UCITS portfolios to act in the best interests of the UCITS when placing orders to deal on behalf of the UCITS with other entities for execution.

1. Management companies should act in the best interests of the UCITS they manage when placing orders to deal on behalf of the managed UCITS with other entities for execution, in the context of the management of their portfolios.

2. Management companies should take all reasonable steps to obtain the best possible result for the UCITS taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of these factors should be determined by reference to the requirements in Box 7.

3. Management companies should establish and implement a policy to enable them to comply with the obligation in paragraph 2. The policy should identify, in respect of each class of instrument, the entities with which the orders are placed. The entities identified should have execution arrangements that enable the management company to comply with its obligations under this Box when it places orders with that entity for execution. Management companies should make available appropriate information to the unitholders on the policy established in accordance with this paragraph and on any material changes to their policy.

4. Management companies should monitor on a regular basis the effectiveness of the policy established in accordance with paragraph 3 and, in particular, the execution quality of the entities identified in that policy and, where appropriate, correct any deficiencies.

In addition, they should review the policy annually. Such review should also be carried out whenever a material change occurs that affects the management company's ability to continue to obtain the best possible result for the managed UCITS.

5. Management companies should be able to demonstrate to the relevant UCITS that they have placed orders on behalf of the UCITS in accordance with the company's policy.

6. This Box should not apply when the management company also executes the decisions to deal on behalf of the UCITS. In those cases Box 7 applies.

Explanatory text

36. As indicated above, CESR considers that, in order to ensure a high level of investor protection, the best execution obligation should apply to management companies regardless of whether the orders are executed directly by the management companies or placed with or transmitted to other entities for execution.

37. Therefore, it is proposed that a management company should not be permitted to select another entity to execute orders on behalf of the UCITS unless it takes all reasonable steps to ensure that the entity achieves the best possible result for the UCITS' orders on a consistent basis. For this purpose, management companies might be required to comply with requirements consistent with

those applying in the provision of the service of individual portfolio management under Article 45 of the MiFID L2 Directive.

38. Management companies are not restricted to using entities subject to the MIFID for carrying out their orders. In order to be able to use an entity that is not subject to the MiFID best execution regime, in particular a non-EEA service provider, management companies should ensure that the execution arrangements of such an entity allow them to comply with the overarching best execution requirement. Where the management company cannot satisfy itself that this is the case, it should not use such entities[22].

39. Due to the specificities of the business of collective portfolio management, the provisions of Article 45(4), second sentence, of the MiFID L2 Directive referring to specific instructions from the client would not be applicable to management companies when performing the collective portfolio management.

[22] Best execution under MiFID – Q&A, May 2007, Ref. CESR/ 07-320

E. Handling of orders related to the execution of portfolio decisions to deal on behalf of the managed UCITS

Level 2 advice

Box 9

General principles

1. Management companies should implement procedures and arrangements which provide for the prompt, fair and expeditious execution of portfolio transactions on behalf of the UCITS.

2. To this purpose, management companies should satisfy the following conditions:

(a) they must ensure that orders executed on behalf of UCITS are promptly and accurately recorded and allocated;
(b) they must carry out otherwise comparable UCITS orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the UCITS require otherwise.

2. Management companies should take all reasonable steps to ensure that any UCITS financial instruments or sums of money, received in settlement of the executed order, are promptly and correctly delivered to the account of the appropriate UCITS.

3. A management company should not misuse information relating to pending UCITS orders, and should take all reasonable steps to prevent the misuse of such information by any of its relevant persons.

Box 10

Aggregation and allocation of trading orders

1. Management companies should not be permitted to carry out a UCITS order in aggregation with an order of another UCITS or another client or with an order made when investing their own funds, unless the following conditions are met:

(a) it must be unlikely that the aggregation of orders will work overall to the disadvantage of any UCITS or clients whose order is to be aggregated;

(b) an order allocation policy should be established and effectively implemented, providing in sufficiently precise terms for the fair allocation of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.

2. Where a management company aggregates an UCITS order with one or more orders of other UCITS or clients and the aggregated order is partially executed, it should allocate the related trades in accordance with its order allocation policy.

3. Management companies which aggregate transactions made when investing their own funds with one or more UCITS or other clients' orders may not allocate the related trades in a way that is detrimental to the UCITS or another client.

If a management company aggregates an order of a UCITS or another client with a transaction made when investing its own funds and the aggregated order is partially executed, it allocates the related trades to the UCITS in priority to the management company. However, if the management company is

able to demonstrate to the relevant UCITS or other client on reasonable grounds that without the combination it would not have been able to carry out the order on such advantageous terms, or at all, it may allocate the transaction for own account proportionally, in accordance with the policy as referred to in paragraph 1 (b).

Explanatory text

40. Investment firms and management companies that provide the service of individual portfolio management are subject to the MiFID rules on client order handling, which are aimed at ensuring the protection and fair treatment of investors. CESR considers it reasonable to extend those rules to management companies in the performance of the collective portfolio management activity.

41. It is therefore proposed that client order handling rules under Article 22(1) of MiFID and Articles 47 (General principles) and 48 (Aggregation and allocation of orders) of the MiFID L2 Directive be adapted to the business of collective portfolio management activity.

42. Conversely, it is considered not to extend Article 47(1)(c) of the MiFID L2 Directive, which imposes the duty to inform retail clients about any material difficulty relevant to the proper carrying out of orders promptly upon becoming aware of the difficulty, nor the disclosure requirement vis-à-vis the client under Article 48(1)(b). The equivalent of the client in the sense of those MiFID provisions should be understood in the context of a management company as the UCITS itself and not as the final investors.

43. In the specific situation of the investment of the own funds of a management company, the provisions of Article 49 of the MiFID L2 Directive (dealing with the aggregation and allocation of transactions carried out for own account) appear to be relevant if the management company decides to aggregate orders for the trades related to the investment of its own funds with orders of managed UCITS.

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F - Inducements

Level 2 advice

Box 11

Inducements

1. Management companies should not be regarded as acting honestly, fairly and professionally in accordance with the best interests of the UCITS if, in relation to the provision of a relevant service to the UCITS, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

(a) a fee, commission or non-monetary benefit paid or provided to or by the UCITS or a person on behalf of the UCITS;

(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, should be clearly disclosed to the UCITS , in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service;
(ii) the payment of the fee or commission, or the provision of the non-monetary benefit should be designed to enhance the quality of the relevant service and not impair compliance with the management company's duty to act in the best interests of the UCITS;

(c) proper fees which enable or are necessary for the provision of the relevant service, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the management company's duties to act honestly, fairly and professionally in accordance with the best interests of the UCITS.

2. Management companies should not be regarded as acting honestly, fairly and professionally in accordance with the best interests of an investor if, in relation to the provision of a relevant service to the investor (direct distribution), they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

(a) a fee, commission or non-monetary benefit paid or provided to or by the investor or a person on behalf of the investor;

(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, should be clearly disclosed to the investor, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service;
(ii) the payment of the fee or commission, or the provision of the non-monetary benefit should be designed to enhance the quality of the relevant service and not impair compliance with the management company's duty to act in the best interests of the investor;

(c) proper fees which enable or are necessary for the provision of the relevant service, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot

give rise to conflicts with the management company's duties to act honestly, fairly and professionally in accordance with the best interests of the investors.

3. A management company should be permitted, for the purposes of points 1 (b)(i) and 2(b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the unitholder and provided that it honours that undertaking.

4. A relevant service means one or more of the functions pertaining to the activity of collective portfolio management as defined under Annex II of the UCITS Directive (including the direct distribution of a UCITS to an investor).

Explanatory text

44. CESR recognises that in the context of portfolio management, inducements are one of the main sources of conflicts of interest and merit specific regulation.

45. Management companies that provide the service of individual portfolio management are already subject to the provisions of Article 21(e) of the MiFID L2 Directive, according to which the situation where the company or a relevant person, or a person directly or indirectly linked by control to the company, receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service, qualifies as a conflict of interest potentially detriment to the client. In addition, Article 26 of the MiFID L2 Directive on inducements applies.

46. The same principles should be extended to the collective portfolio management (as defined under Annex II of the UCITS Directive) business, subject to the necessary adjustments.

47. In particular, in light of the overarching principle of investor protection, it appears to be appropriate to provide that management companies should be allowed to give or receive certain inducements only subject to specific conditions, and provided they are disclosed to the UCITS or the investors, or are given to or by a UCITS or an investor or a person on behalf of a UCITS or an investor. The above-mentioned conditions could be designed consistently with the provisions of Article 26 of the MiFID L2 Directive.

48. The conditions regarding inducements apply in relation to the provision of a relevant service. When applying those conditions, a management company should thus always take into account the type of service and the person to whom the service is to be provided (UCITS or investor). Indeed, the specific relationship at stake may have an impact on the application of the conditions. For example, when distributing units of UCITS, the management company should distinguish the two relationships that could possibly exist (and apply accordingly the conditions): on the one hand, the relationship between the management company and the UCITS and, on the other hand, the relationship between the management company and the relevant investor.

49. In order to ensure consistency and a level playing field, CESR's level 3 Recommendations on Inducements under MiFID (as well as any further level 3 work by CESR about inducements) should be taken into account in defining the requirements of Box 11. For instance, management companies may consider that the following factors should, inter alia, be taken into account in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided and not impair the duty of the company to act in the best interests of the UCITS or the investors:

    (a) the type of the collective management service or activity provided by the management company to the managed UCITS and to the investors;

(b) the expected benefit to the UCITS and/or to the investors, including the nature and extent of that benefit, and any expected benefit to the management company; the analysis of the expected benefit can be performed at the level of the service to the managed UCITS or to the relevant investors;

(c) whether there will be an incentive for the management company to act otherwise than in the best interests of the managed UCITS or of the relevant investors, and whether the incentive is likely to change the management company's behaviour;

(d) the relationship between the management company and the entity which is receiving or providing the benefit;

(e) the nature of the benefit, the circumstances in which it is paid or provided and whether any conditions attach to it.

50. Inducements paid or received in relation to the provision of a collective portfolio management activity to the UCITS or to the investor (the latter in the case of direct distribution) should be disclosed ex-ante to the client (the UCITS or investor) to whom the activity is being provided, in accordance with the MiFID requirements (see paragraph 1(b) of Box 11).

51. Ex-ante information to the UCITS should be understood as covering also their unitholders. The ex-ante information to the unitholders should be provided in any appropriate and durable medium (e.g. UCITS' website, UCITS' prospectus etc). However, since arrangements involving inducements may also be set up after the initial offering of the fund, unitholders may become affected by such arrangements at a time when they have already purchased the units/shares of the relevant UCITS. In such situations therefore, in practice, disclosures towards current unitholders may only be done ex post, possibly on a periodic basis (for example in the periodic reports).

52. If the above-mentioned conditions and requirements are not complied with, management companies should not be regarded as acting honestly and fairly in accordance with the best interests of the UCITS or investors as prescribed by Article 14 of the UCITS Directive.

ANNEX 1

Excerpt from MiFID

Article 21 of MiFID states that:

'1. Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.
Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

2. Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.

3. The order execution policy shall include, in respect of each class of instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.
Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. Member States shall require that investment firms obtain the prior consent of their clients to the execution policy.
Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the investment firm shall, in particular, inform its clients about this possibility. Member States shall require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a regulated market or an MTF. Investment firms may obtain this consent either in the form of a general agreement or in respect of individual transactions.

4. Member States shall require investment firms to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements. Member States shall require investment firms to notify clients of any material changes to their order execution arrangements or execution policy.

5. Member States shall require investment firms to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy'.

ANNEX II

Excerpt from MiFID L2 Directive 2006/73/EC

Article 26 of the MiFID L2 Directive provides that:

'Member States shall ensure that investment firms are not regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if, in relation to the provision of an investment or ancillary service to the client, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

(a) a fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client;

(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:
(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service;
(ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client;

(c) proper fees which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.

Member States shall permit an investment firm, for the purposes of point (b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the client and provided that it honours that undertaking'.

Article 44 of the MiFID L2 Directive provides that:

'1. Member States shall ensure that, when executing client orders, investment firms take into account the following criteria for determining the relative importance of the factors referred to in Article 21(1) of Directive 2004/39/EC:
(a) the characteristics of the client including the categorisation of the client as retail or professional;
(b) the characteristics of the client order;
(c) the characteristics of financial instruments that are the subject of that order;
(d) the characteristics of the execution venues to which that order can be directed.
For the purposes of this Article and Article 46, 'execution venue' means a regulated market, an MTF, a systematic internaliser, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

2. An investment firm satisfies its obligation under Article 21(1) of Directive 2004/39/EC to take all reasonable steps to obtain the best possible result for a client to the extent that it executes an order or a specific aspect of an order following specific instructions from the client relating to the order or the specific aspect of the order.

3. Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution, which shall include all expenses incurred by the client which are directly

related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.
For the purposes of delivering best execution where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the firm's order execution policy that is capable of executing that order, the firm's own commissions and costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.

4. Member States shall require that investment firms do not structure or charge their commissions in such a way as to discriminate unfairly between execution venues'.

Article 45 of the MiFID L2 Directive reads as follows:

'1. Member States shall require investment firms, when providing the service of portfolio management, to comply with the obligation under Article 19(1) of Directive 2004/39/EC to act in accordance with the best interests of their clients when placing orders with other entities for execution that result from decisions by the investment firm to deal in financial instruments on behalf of its client.

2. Member States shall require investment firms, when providing the service of reception and transmission of orders, to comply with the obligation under Article 19(1) of Directive 2004/39/EC to act in accordance with the best interests of their clients when transmitting client orders to other entities for execution.

3. Member States shall ensure that, in order to comply with paragraphs 1 or 2, investment firms take the actions mentioned in paragraphs 4 to 6.

4. Investment firms shall take all reasonable steps to obtain the best possible result for their clients taking into account the factors referred to in Article 21(1) of Directive 2004/39/EC. The relative importance of these factors shall be determined by reference to the criteria set out in Article 44(1)and, for retail clients, to the requirement under Article 44(3). An investment firm satisfies its obligations under paragraph 1 or 2, and is not required to take the steps mentioned in this paragraph, to the extent that it follows specific instructions from its client when placing an order with, or transmitting an order to, another entity for execution.

5. Investment firms shall establish and implement a policy to enable them to comply with the obligation in paragraph 4. The policy shall identify, in respect of each class of instruments, the entities with which the orders are placed or to which the investment firm transmits orders for execution. The entities identified must have execution arrangements that enable the investment firm to comply with its obligations under this Article when it places or transmits orders to that entity for execution.
Investment firms shall provide appropriate information to their clients on the policy established in accordance with this paragraph.

6. Investment firms shall monitor on a regular basis the effectiveness of the policy established in accordance with paragraph 5 and, in particular, the execution quality of the entities identified in that policy and, where appropriate, correct any deficiencies. In addition, investment firms shall review the policy annually. Such a review shall also be carried out whenever a material change occurs that affects the firm's ability to continue to obtain the best possible result for their clients.

7. This Article shall not apply when the investment firm that provides the service of portfolio management and/or reception and transmission of orders also executes the orders received or the decisions to deal on behalf of its client's portfolio. In those cases Article 21 of Directive 2004/39/EC applies.'

Pursuant to **Article 46** of the MiFID L2 Directive:

'1. Member States shall ensure that investment firms review annually the execution policy established pursuant to Article 21(2) of Directive 2004/39/EC, as well as their order execution arrangements. Such a review shall also be carried out whenever a material change occurs that affects the firm's ability to continue to obtain the best possible result for the execution of its client orders on a consistent basis using the venues included in its execution policy.

2. Investment firms shall provide retail clients with the following details on their execution policy in good time prior to the provision of the service:
(a) an account of the relative importance the investment firm assigns, in accordance with the criteria specified in Article 44(1), to the factors referred to in Article 21(1) of Directive 2004/39/EC, or the process by which the firm determines the relative importance of those factors;
(b) a list of the execution venues on which the firm places significant reliance in meeting its obligation to take all reasonable steps to obtain on a consistent basis the best possible result for the execution of client orders;
(c) a clear and prominent warning that any specific instructions from a client may prevent the firm from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions.
That information shall be provided in a durable medium, or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in Article 3(2) are satisfied'.

Article 47 of the MiFID L2 Directive states:

'Member States shall require investment firms to satisfy the following conditions when carrying out client orders:
(a) they must ensure that orders executed on behalf of clients are promptly and accurately recorded and allocated;
(b) they must carry out otherwise comparable client orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the client require otherwise;
(c) they must inform a retail client about any material difficulty relevant to the proper carrying out of orders promptly upon becoming aware of the difficulty.

2. Where an investment firm is responsible for overseeing or arranging the settlement of an executed order, it shall take all reasonable steps to ensure that any client financial instruments or client funds received in settlement of that executed order are promptly and correctly delivered to the account of the appropriate client.

3. An investment firm shall not misuse information relating to pending client orders, and shall take all reasonable steps to prevent the misuse of such information by any of its relevant persons'.

According to **Article 48** of the MiFID L2 Directive:

'Member States shall not permit investment firms to carry out a client order or a transaction for own account in aggregation with another client order unless the following conditions are met:
(a) it must be unlikely that the aggregation of orders and transactions will work overall to the disadvantage of any client whose order is to be aggregated;
(b) it must be disclosed to each client whose order is to be aggregated that the effect of aggregation may work to its disadvantage in relation to a particular order;
(c) an order allocation policy must be established and effectively implemented, providing in sufficiently precise terms for the fair allocation of aggregated orders and transactions, including how the volume and price of orders determines allocations and the treatment of partial executions.

2. Member States shall ensure that where an investment firm aggregates an order with one or more other client orders and the aggregated order is partially executed, it allocates the related trades in accordance with its order allocation policy.'

Section III

CESR's technical advice to the European Commission on measures to be taken by a depositary in order to fulfil its duties regarding a UCITS managed by a management company situated in another Member State, including the particulars that need to be included in the standard agreements to be used by the depositary and the management company (Articles 22 and 23 of the UCITS Directive)

INTRODUCTION

1. Article 23 of the UCITS Directive states that:

   1. A depositary shall either have its registered office in the UCITS home Member State or be established in that Member State if its registered office is in another Member State.

   2. A depositary shall be an institution which is subject to prudential regulation and on-going supervision. It shall also furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that function.

   3. Member States shall determine which of the categories of institutions referred to in paragraph 2 shall be eligible to be depositaries.

   4. The depositary shall enable the competent authorities of the UCITS home Member State to obtain on request all information, which the depositary has obtained while discharging its duties, and which are necessary for the competent authorities to supervise compliance of the UCITS with the requirements under this Directive.

   5. If the management company's home Member State is not the UCITS home Member State, the depositary shall sign a written agreement with the management company regulating the flow of information deemed necessary to allow it to perform the functions referred to in Article 22 and in other laws, regulations and administrative provisions which are relevant for depositaries in the UCITS home Member State.

   6. The Commission may adopt implementing measures on the measures to be taken by a depositary in order to fulfil its duties regarding a UCITS managed by a management company situated in another Member State, including the particulars that need to be included in the standard agreements to be used by the depositary and the management company as referred to in paragraph 4.

      Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 112(2).

2. Article 33 mirrors these provisions as regards investment companies.

3. The Commission's mandate asks CESR to provide advice on the matters listed below.

   1. CESR is requested to advise the Commission on the specific conditions that a depositary must meet to fulfil its duties regarding a UCITS managed by a management company situated in another country.
   2. CESR is requested to advise the Commission on standard arrangements between the depositary and management company and identify the particulars of the agreement between them that are required under Articles 23(6) and 33(6) and the regulation of the flow of information deemed necessary to allow the depositary to discharge its duties.
   3. CESR is invited to consider the need to regulate through level 2 measures the law applicable to the agreement in order to remove legal uncertainty (whether the agreement should be governed by law of UCITS home Member State, management company home Member State or of any other Member State).

4. CESR should provide its technical advice in form of an 'articulated' text by 30 October 2009 at the latest.

5. The present advice has been prepared taking due account of the overarching principle of a high level of investor protection and supervision, also in the light of the recent developments in the financial markets. It is drafted on the basis of the text of the UCITS Directive as adopted by the Council on 22 June 2009.

6. The principle of proportionality has also been taken into account, with a view to avoiding creating excessive administrative or procedural burdens either on UCITS management companies or depositaries.

DEFINITIONS

'UCITS Directive' means the Directive on undertakings for collective investment in transferable securities adopted by the Council on 22 June 2009, following a first-reading agreement with the European Parliament (position of the European Parliament adopted on 13 January 2009).

'Depositary' means any institution entrusted with the duties mentioned in Articles 22 and 32 and subject to the other provisions laid down in Chapter IV and Section 3 of Chapter V of the UCITS Directive.

'Management company' means any company, the regular business of which is the management of UCITS in the form of common funds and/or of investment companies (collective portfolio management of UCITS). In the following, all references to 'management company(ies)' intend to cover management companies that manage UCITS [common] funds as well as all UCITS that have an investment company form. CESR considers that investment companies should not be treated differently from management companies for the purposes of the agreement between the depositary and the management company. Therefore, this advice should apply to both management companies that manage UCITS and to investment companies that are self-managed UCITS. Any reference herein to management companies should accordingly be read also as a reference to such investment companies.

For the purposes of this document, the regular business of a management company shall include the functions mentioned in Annex II of the UCITS Directive.

'Management company's home Member State' means the Member State in which the management company has its registered office. A management company's host Member State means the Member State, other than the home Member State, within the territory of which a management company has a branch or provides services;

'UCITS' refers to undertakings for collective investment in transferable securities as harmonised by the above-mentioned UCITS Directive.

'UCITS home Member State' means the Member State in which the UCITS is authorised pursuant to Article 5 of the UCITS Directive. UCITS host Member State means the Member State, other than the UCITS home Member State, in which the units of the common fund or of the investment company are marketed;

'Competent authorities' means the authorities which each Member State designates under Article 97 of the UCITS Directive.

1. Specific conditions that a depositary must meet to fulfil its duties regarding a UCITS managed by a management company situated in another country

Box 1

Apart from entering into a written agreement with the management company as required by Articles 23(5) and 33(5) of the UCITS Directive, CESR does not see specific conditions that a depositary must fulfil when the assets of a UCITS that is managed by a management company situated in another Member State (management company passport) are entrusted to it.

Explanatory text

1. CESR does not see grounds for the overall framework applicable to depositaries acting in a domestic context (the UCITS/management company are domiciled in the same Member State) being different from cross-border situations (use of the management company passport) – see section 5 below.
2. When a UCITS is managed by a management company situated in another Member State (use of the management company passport), the level 1 provisions of the UCITS Directive require that the management company and the depositary enter into a written agreement governing their relationship. Specifically, the depositary shall sign a written agreement with the management company regulating the flow of information necessary to allow it to perform its function. CESR suggests that such a requirement could be extended to domestic situations. Given that this is already the case in many Member States, the implementation costs should be limited and it would ensure a level playing field for depositaries.

2. The standard arrangements between the depositary and management company and identification of the particulars of the agreement between them as required under Articles 23(6) and 33(6) and the regulation of the flow of information deemed necessary to allow the depositary to discharge its duties

Box 2

The depositary and the management company shall draw up a written agreement setting out the rights and obligations of both parties.

This agreement shall include at least the following elements:

1. A description of the services provided by the depositary and the procedures (including those related to the safekeeping activity) adopted for each type of asset pertaining to the UCITS entrusted to the depositary; and, where custody is delegated, a mention that such delegation does not affect depositary liability as defined by the UCITS Directive;
2. The period of validity, and the conditions for amendment and termination of the contract, including a condition that the contract should not allow for a termination procedure that would hinder the smooth transition to a successor; and, if applicable, the procedures by which the depositary should send all relevant information to its successor;
3. The confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of respectively the management company home Member State competent authorities and the depositary and UCITS' home Member State competent authorities to have access to the relevant documents and information;
4. The means and procedures by which the depositary will transmit to the management company all relevant information that the latter needs to perform its duties including the exercise of any rights attached to financial instruments, and in order to allow the management company and the UCITS to have a timely and accurate situation of the accounts of the UCITS. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;
5. The means and procedures that may be necessary in order to allow the depositary to have access to all the information needed, so as to allow it to fulfil its safekeeping and oversight duties. The details of such means and procedures should be described in the service level agreement or similar document;
6. The procedures to be followed when the management company envisages a modification to the fund rules or full prospectus of the UCITS, detailing the situations in which the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;
7. All necessary information that needs to be exchanged between the UCITS / management company and the depositary related to the sale, issue, re-purchase, redemption and cancellation of units of the UCITS;
8. An undertaking to provide, on a regular basis, as may be agreed between the management company and the depositary:
    a. details of any third parties appointed by the depositary to carry out part of its duties (e.g. custody of financial instruments and cash), where applicable; and an agreement to provide information on the criteria used by the depositary to select and monitor such outsourcees in compliance with the legal provisions governing such delegation at the request of the management company;
    b. details of any third parties appointed by the management company to carry out part of its duties, where applicable; and an agreement to provide information on the criteria used by the management company to select and monitor such outsourcees in compliance with the legal provisions governing such delegation at the request of the depositary;

9. All information regarding the tasks and responsibilities in respect of obligations regarding anti-money laundering and combating the financing of terrorism, where applicable.

Subject to national law, there shall be no obligation to enter into a specific written agreement for each UCITS; it shall be possible for the management company and the depositary to enter into a framework agreement listing the UCITS to which it applies.

The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured.

The agreement shall include the procedures by which the depositary, in respect of its duties, has the ability to enquire into the conduct of the management company and to assess the quality of the information transmitted, including by way of on-site visit. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the management company in respect of the depositary's contractual obligations.

The law applicable to the agreement shall be specified (i.e. the national law of the UCITS' home Member State[23]).

Explanatory text

3. The location of the depositary in another Member State should not hamper the prompt access by the depositary and the management company to all information needed to perform their respective duties.

4. According to Article 22 of the UCITS Directive:

> '1. A common fund's assets must be entrusted to a depositary for safe-keeping.
>
> […]
>
> 3. A depositary shall:
>
> a) ensure that the sale, issue, re-purchase, redemption and cancellation of units effected on behalf of a common fund or by a management company are carried out in accordance with the law and the fund rules;
>
> b) ensure that the value of units is calculated in accordance with the law and the fund rules;
>
> c) carry out the instructions of the management company, unless they conflict with the law or the fund rules;
>
> d) ensure that in transactions involving a common fund's assets any consideration is remitted to it within the usual time limits;
>
> e) ensure that a common fund's income is applied in accordance with the law and the fund rules.

5. Article 32 of the UCITS Directive, which deals with obligations of the depositary when UCITS are investment companies, reads:

> '1. An investment company's assets shall be entrusted to a depositary for safe-keeping.
>
> […]
>
> 3. A depositary shall ensure the following:
>
> a) that the sale, issue, re-purchase, redemption and cancellation of units effected by or on behalf of a company are carried out in accordance with the law and with the company's instruments of incorporation;
>
> b) that in transactions involving a company's assets any consideration is remitted to it within the usual time limits;

[23] See Box 3.

c) that a company's income is applied in accordance with the law and its instruments of incorporation.

[…]

6. These provisions were already contained in Articles 7 and 14 of the UCITS Directive 85/611/EC and are unchanged since 1985.

7. These obligations imply that the depositary must receive sufficient information to perform these tasks. The information needed by the depositary to perform its tasks[24] includes all information related to transactions on the UCITS' assets, such as:

   - Information on sale or purchase of assets such as transferable securities and money-market instruments.
   - Information on financial derivative instruments: the depositary must be aware and record the position of any financial derivative transactions into which the management company has entered on behalf of a UCITS.
   - Information on other forms of financial contracts (stock lending, repurchase agreements where permitted, guarantees received or given, where applicable, by the UCITS) that may have an impact on the net asset value of the UCITS.
   - Information on collateral arrangements.

8. Conversely, all operations executed by the depositary upon request from the management company need to be reported appropriately to the management company, and all events regarding the securities or the contracts held by the UCITS of which the depositary is informed must be reported to the management company.

9. In the context of the management company passport, it is essential that the depositary and the management company agree on how they will work together in order to ensure that the host member state regulation regarding UCITS be complied with. This is the case notably in the field of confidentiality agreements, and in the event of change to the fund rules of the UCITS (some member states require the approval of the depositary before the fund rules or the full prospectus are modified).

10. The drafting of standard agreement terms seems inappropriate, as the precise drafting may depend on the applicable law. It is therefore proposed that the CESR advice include a set of general requirements on the content of the agreement, without extending to the provision of a precise set of standard agreement terms.

11. The agreement shall include standard information, such as:

    - The general information regarding the agreement itself: period of validity; conditions of termination; confidentiality obligations;
    - Detailed description of the object of the agreement, and notably:
        - description of the services provided by the depositary; indication whether the depositary may delegate some of its duties;
        - description of all means and procedures regarding the necessary flow of information between the depositary and the management company in order to allow the management company on the one hand and the depositary on the other hand to perform their respective duties and to comply with their respective legal requirements, which includes, in particular, all information related to transactions on the UCITS' assets;
    - Information on delegation arrangements by each party to the agreement;

[24] For instance, the depositary has to ensure the value of the units is calculated in accordance with the law and fund rules, especially with respect to illiquid assets;

- Information on relevant legal provisions applicable to each party and exchange of information, where needed, between parties in order to allow each of them to fully comply with all applicable regulatory provisions (for instance, the means and procedures adopted in order to identify, prevent, manage and disclose depositary's conflict of interest).

12. In addition, the agreement should refer, where applicable, to anti-money laundering and terrorist financing provisions. According to Article 3(2)(d) of Directive 2005/60 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, the Directive applies also to a collective investment undertaking marketing its units or shares. Although in the case of UCITS most of the contacts with clients and unitholders are kept through other intermediaries already subject to anti money-laundering regulations, it may happen that national legislations require asset management companies to perform activities in relation to anti money-laundering obligations. In such a case it is important that the allocation of responsibility between the management company and the depositary is clearly stated in the agreement, especially when cross-border management is involved.

13. It is worth noting that Article 23(6) of the UCITS Directive provides that the Commission may adopt level 2 provisions regarding the measures to be taken by a depositary in order to fulfil its duties regarding a UCITS managed by a management company situated in another Member State, including the particulars that need to be included in the standard agreements to be used by the depositary and the management company. CESR considers that, although the above-mentioned level 2 measures are not mandatory, there are strong grounds for seeking to achieve harmonisation, notably through imposing clear and detailed level 2 rules.

14. Finally, CESR carefully considered the split between level 2 and level 3 measures in respect of the standard arrangements between the depositary and management company and identification of the particulars of this agreement. In particular, CESR has taken account of the need for harmonisation regarding the rules that will apply to cross-border situations. Such a harmonisation is easier to achieve by imposing prescriptive rules at level 2. On the other hand, considering the degree of technicality of some provisions, CESR is of the view that some technical rules should be left at level 3. Furthermore, level 3 recommendations will help implement the suggested level 2 measures and avoid divergent interpretation.

15. CESR envisages, therefore, elaborating level 3 guidelines which would recommend that the written agreement between the depositary and the management company should be understood as including at least the following elements:

- Information that the depositary will transmit to the management company should amount to all relevant information, such as and where applicable:
  a. regarding the conditions in which the transaction orders of the management company have been executed;
  b. regarding the conditions in which the transactions have been settled;
  c. regarding the operations executed by the depositary (e.g. registration of coupons, payment of dividends, margin calls);
  d. that will allow the management company or the UCITS to exercise the rights attached to the securities or contracts held by the UCITS (e.g. corporate actions requiring a response from the holder, or events affecting holder's rights);
  e. all other information that the management company requires to perform its duties.
- The information that the depositary needs to have access to so as to allow it to fulfil its duties should, where applicable, cover:
  a. information on the sale or purchase of financial instruments and relevant documentation related to such transactions;
  b. information on deposits and documents related to such operations;

c. information on financial derivative instruments transactions and their characteristics, and documents related to such transactions;

d. information on financial contracts in which the management company has entered in the name of the UCITS, such as collateral arrangements, stock lending contracts, repurchase or reverse-repurchase agreements where permitted, that may have an impact on the valuation or the respect of the applicable law and the fund rules by the UCITS;

e. other relevant information that may be material to the UCITS in order to respect the applicable law and the fund rules (e.g. decision to suspend the publication of the net asset value of the UCITS, documents that may be necessary to materialize the title of ownership of a given security);

- The agreement should provide for the arrangements relevant to the clearing of derivative financial instruments.
- The agreement should also detail all additional relevant information on the regulation applying to the depositary, the management company or the UCITS, and all corresponding information that needs to be exchanged between them so that they can comply with this regulation (e.g. for establishment of tax returns).

16. In addition CESR acknowledges that depositaries and management companies may wish to use electronic means for the purpose of information exchange. CESR could, therefore, recommend level 3 guidelines stipulating that, where this is the case, the agreement must state that the applicable law regarding exchange of information (notably as regards requirements to keep records) using electronic means will be that of the depositary's home Member State.

3. Level 2 measures on the law applicable to the agreement between the management company and the depositary

Box 3
The agreement between the management company and the depositary that is required under Articles 23(5) and 33(5) should be governed by the national law of the UCITS' home Member State.

Explanatory text

17. As indicated above, the Commission asked CESR to advise on whether the agreement between the depositary and the management company should be governed by the law of UCITS home Member State, management company home Member State or of any other Member State.

18. In CESR's advice to the European Commission on the UCITS Management Company Passport, it is stated that 'The UCITS should be regulated in accordance with the law applicable in its home Member State' (Box 2).

19. It seems reasonable to require the agreement between the management company and the depositary to be governed by the same law which governs the UCITS (i.e. the law of the UCITS home Member State).

4. Need for different provisions in relation to investment companies

Box 4

CESR considers that investment companies should not be treated differently from common funds in respect of the provisions covered by the present consultation paper.

Explanatory text

20. In the provisional mandate, the Commission points out that CESR is free to indicate whether investment companies should be treated differently for the purposes of these provisions in the context of cross-border situations.

21. However, CESR does not see any grounds for a different approach. The level 2 provisions that are suggested as regards the relation between the depositary and the management company that makes use of the passport should apply equally whether the UCITS is a common fund or an investment company.

5. Possibility to advise the European Commission to extend these requirements to domestic structures (depositary and management company / UCITS domiciled in the same Member State)

Box 5

CESR considers that the requirements in this paper should also apply when the UCITS and the management company are in the same Member State.

Explanatory text

22. CESR considers that it could be envisaged to advise (at level 2 or 3) to extend these requirements to the situation where the UCITS, the management company and the depositary are domiciled in and regulated by the same Member State.

23. In the absence of possible level 2 provisions in the level 1 Directive, CESR's suggestion in this Box 5 constitutes a level 3 recommendation. However, CESR envisages reflecting on whether and how level 1 provisions or amendments to existing level 1 provisions, relevant to this area could be proposed.

24. While this may be seen as imposing a more burdensome regime on depositaries acting in a purely domestic situation, it should encourage the development of a level playing field for depositaries acting in both situations (domestic or cross-border). Such a harmonisation of rules applicable to purely domestic situations with cross-border situations may lead on the one hand to specific costs to the asset management industry. However, it may contribute to a higher level of investor protection and to a more homogeneous regulation of UCITS throughout the EU i.e. towards a level playing field in this sector.

Section IV
CESR's technical advice to the European Commission on the implementing measures on risk management (Article 51(4)(a) of the UCITS Directive)

INTRODUCTION

Background

1. Article 51(4) of the UCITS Directive provides that the Commission shall adopt, by 1 July 2010, implementing measures specifying the following:

   i. criteria for assessing the adequacy of risk management process employed by the management company;
   ii. detailed rules regarding the accurate and independent assessment of the value of the OTC derivatives;
   iii. detailed rules regarding the content and the procedure to be followed for communicating the information to the competent authorities of the management company's home Member State referred to in the third sentence of paragraph 1.

2. As outlined in the Commission's mandate, obligations provided for in Article 51 of the UCITS Directive are complemented by the conditions imposed on the basis of Article 12 concerning sound administrative and accounting procedures, control and safeguarding arrangements for electronic data processing as well as adequate internal control mechanisms, which constitute the organisational and procedural basis for the overall risk management process.

3. CESR is invited to provide its technical advice on possible implementing measures under the above-mentioned Article 51(4) of the UCITS Directive by 30 October 2009 at the latest.

CESR is invited to advise the Commission on the following questions:

What should be the conditions that govern risk management processes that can be employed by management/investment companies?

CESR is invited to establish the criteria that competent authorities should take into account when determining whether the risk management process employed by the management company is adequate for monitoring and measuring at any time the risk of a position and its contribution to the overall risk profile of the portfolio. In particular CESR is requested:

a) to advise on the categories of material risks that are relevant for UCITS (the identification of types of risks that should be addressed),

b) to advise on principles governing the identification of the particular material risks relevant for a particular UCITS related to each portfolio position and their contribution to the overall risk profile of the portfolio,

c) to advise, to the extent possible, on requirements concerning risk measurement methods, such as the conditions for the use of different methodologies in relation to the identified types of risk and the specific criteria under which these methodologies might be used,

d) to establish principles for risk management processes to be employed in order to mitigate or otherwise manage and monitor the identified risks related to each portfolio position and their contribution to the overall risk profile of the portfolio. This could include requirements for management companies to ensure proper functioning of risk management processes, establishment of criteria for assessing the effectiveness of risk management processes, setting out principles for systems

for operating risk limits, and / or the definition of reporting and monitoring obligations. This list is not intended to be exhaustive or a final indication of the necessary elements, and CESR should consider the best overall package of measures necessary for ensuring sound risk management processes are in place for UCITS.

In relation to derivative instruments, CESR is in particular requested to recommend principles for calculating the global exposure related to derivative instruments, and measures that UCITS must undertake to ensure that global exposure relating to derivative instruments does not exceed the total net value of its portfolio.

What should be the content of the detailed rules regarding the accurate and independent assessment of the value of OTC derivatives as referred to in Article 51(1)?

What detailed rules should govern the content and the procedure to be followed by the management company for communicating the information mentioned in Article 51(1) to the competent authorities of its home Member State?

General approach

4. The present advice covers point 1 of the box above relating to the conditions that govern risk management processes that can be employed by management companies.

5. This advice is intended to apply, mutatis mutandis, also to self-managed investment companies (see Box 8).

6. In accordance with the EC Provisional Mandate, when preparing this advice, CESR has taken into account:

   - the CESR Risk Management Principles for UCITS published on 27 February 2009 (CESR/09-178) and results of on-going discussion within the CESR Investment Management Expert Group on specific technical and quantitative issues regarding UCITS portfolio parameters for measuring global exposure, leverage and counterparty risk;

   - the extensive work CESR has already been carrying out on similar MiFID implementing rules, with a view of increasing coherence between systems put in place by both directives;

   - the relevant provisions in Directive 2006/48/EC relating to the taking up and pursuit of credit institutions, with regard, where appropriate, to the definition of the various types of risks;

   - the principle of proportionality and the need to ensure a high level of investor protection and supervision.

7. CESR has taken due account of the specificities of the UCITS area and the recent developments in the financial markets, which underlined the vital importance of adequate risk management.

8. CESR was invited to consider to what extent the Commission Recommendation 2004/383/EC should be taken into account in the content of level 2 implementing measures.

9. CESR published a consultation paper on 15 July 2009 on its technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure (Ref. CESR/09-489). As set out in that consultation, the measures resulting from CESR's work on risk measurement will be split between level 2 and level 3. CESR will bring the level 3 guidelines which will accompany the implementing measures into effect as a single package and in parallel with the deadline of 1 July 2010 for adoption by the Commission of the level 2 measures.

DEFINITIONS

'Board of directors' means the board of directors of the management company. Regarding management companies with a dual structure (board of directors and supervisory board), the term 'board of directors' does not comprise the supervisory board.'

'Counterparty risk' means the risk that the counterparty to a transaction could default on its obligations before the final settlement of the transaction's cash flow.

'Investment company' means any company authorised under Article 27 of the UCITS Directive.

'Liquidity risk' means the risk that a position in the UCITS portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame and the ability of the UCITS to comply at any time with Article 84(1) of the UCITS Directive is compromised.

'Market risk' means the risk of fluctuation in the market value of a position attributable to changes in market variables, such as interest rates, foreign exchange rates. equity and commodity prices and issuer's credit worthiness.

'Management company' means any company, the regular business of which is the management of UCITS in the form of common funds and/or of investment companies (collective portfolio management of UCITS).

'The mandate' means the European Commission's *Provisional Request to CESR for Technical Advice on Possible Implementing Measures Concerning the Future UCITS Directive*, February 13, 2009.

'MiFID' means Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments.

'MiFID L2 Directive' means the Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms.

'Operational risk' means the risk of loss for the UCITS resulting from inadequate or failed internal processes, people and systems of the management company or from external events, and includes legal and documentation risk and risk resulting from the trading, settlement and valuation procedures operated on behalf of the UCITS.

'Senior management': the person or persons who effectively conduct the business of a management company or an investment company according respectively to Article 7(1)(b) and Article 29(1)(b) of the UCITS Directive.

'Supervisory function' means the function appointed to examine and evaluate the adequacy and effectiveness of the risk management process.

'UCITS Directive' means the Directive on undertakings for collective investment in transferable securities adopted by the Council on 22 June 2009, following a first-reading agreement with the European Parliament (position of the European Parliament adopted on 13 January 2009).

'Value at risk' measures the maximum expected loss at a given confidence level (probability) over a specific time period.

CHAPTER I

CONDITIONS GOVERNING RISK MANAGEMENT PROCESSES AND PROCEDURES FOR THE VALUATION OF OTC DERIVATIVES

Implementation of Articles 51(4)(a) and 51(4) (b) of the UCITS Directive

1. Identification of risks relevant to the UCITS

Box 1

Identification of risks and risk management policy

1. Management companies shall establish, implement and maintain an adequate and documented risk management policy which identifies the risks the UCITS they manage are or might be exposed to. In particular, the risk management policy shall comprise procedures which enable the management company to assess the exposure to market risks, liquidity risks, counterparty risks and to all other risks, including operational risks, which might be material to each UCITS it manages.

2. Management companies shall identify in the risk management policy the techniques, tools and arrangements that enable them to comply with the obligations in Box 4.

3. For the purposes of paragraphs 1 and 2, management companies shall take into account the nature, scale and complexity of their business and of the UCITS they manage.

1. In the mandate from the Commission, it is stated that: 'Fund managers must employ sufficiently robust and effective procedures and techniques, along with the associated resource commitments, to adequately manage the different types of risk a UCITS might face – such as market risk, operational risk, legal and documentation risk, counterparty risk, liquidity risk etc.'.

2. According to the European Commission, 'level 2 measures should seek to establish a uniform and consistent approach to the whole risk management process for UCITS, spanning all the risks associated with portfolio positions (e.g. possible impact of future market developments, counterparty risk, the time available to liquidate positions) and the contribution of these to the overall risk profile of the portfolio. Based on Article 51(1), requirements to capture, measure and manage risks shall not be limited to derivative instruments and instruments embedding derivatives but a robust risk management framework for UCITS should cover all portfolio positions. The Commission requests CESR's advice on developing a structured approach to ensuring adequate risk management processes are in place for all UCITS. To deliver this robust risk management framework, all relevant risks related to the activities of UCITS must be duly and accurately identified, managed and monitored'.

3. In CESR's Risk Management Principles for UCITS (Box 5), it is stated that 'Relevant risks should be identified among all possible risks incurred by a UCITS, according to the methods and principles defined by the risk management policy of the Company. The risk management process should assess and address all risks relevant to the UCITS.' In particular, 'The risk management process should regard as relevant the material risks that stem from the

investment objective and strategy of the UCITS, the trading style in managing the UCITS and the valuation process. Material risks should be understood as those risks that can be expected, with reasonable level of confidence, to directly affect the interest of unit-holders.'

4. In accordance with the above, it is proposed that all risks the UCITS is or might be exposed to are identified, measured, managed and monitored. In particular, reference is made to market risks, liquidity risks, counterparty risks and to all other risks, including operational risks, which might be material to each UCITS managed by the management company. Both general risks and specific risks should be assessed. As pointed out in CESR's Risk Management Principles for UCITS, operational risks are considered material to the UCITS to the extent that they also affect investors' interests by their direct impact on the fund's portfolio.

5. In accordance with the Risk Management Principles for UCITS, the risk management policy should:

   (i) define principles and methods for the periodic identification of the risks relevant to the UCITS;
   (ii) specify the techniques and tools that are deemed suitable to measure the risk relevant to the UCITS;
   (iii) specify the method selected to measure the UCITS global exposure as elaborated in Box 9;
   (iv) identify the allocation of roles and responsibilities for the different parts of the risk management process;
   (v) set out, among the arrangements referred to in Box 1, the terms of the interaction between the risk and the investment management functions in order to keep the UCITS risk profile under control and consistent with the UCITS investment strategy;
   (vi) define the reporting arrangements to the board of directors and senior management as elaborated in Box 5.

6. The risk management policy should take the form of a separate document. Where it is not proportionate to have a separate risk management policy, it can also be documented within the existing organisational and procedural rules, provided that the different documents allow for a clear identification of risk management roles, responsibilities and operating procedures.

2. Risk management function

Box 2

Risk management function

1. The risk management function must have the necessary authority, resources, expertise and access to all relevant information.

2. The risk management function shall be hierarchically and functionally independent from the operating units, where appropriate and proportionate in view of the nature, scale and complexity of the management company's business and of the UCITS it manages.

3. The risk management function shall carry out the following tasks:

(a) implementation of the risk management policy and procedures;
(b) ensuring the UCITS risk limit system, including statutory limits concerning global exposure and counterparty risk in accordance with Boxes 9 and 12, is complied with;
(c) provision of advice to the board of directors for the identification of the risk-profile of the UCITS;
(d) provision of reports to the board of directors and senior management in accordance with Box 5;

(e) review and provision, where appropriate, of support concerning the arrangements and procedures for the valuation of assets which involve complex risks as elaborated in Box 6.

4. The method for determining the remuneration of the persons involved in the risk management function shall not compromise their objectivity and shall not be likely to do so.

5. Where a management company is not required under paragraph 2 to establish and maintain a risk management function that is functionally and hierarchically independent from the operating units, it must nevertheless be able to demonstrate that the risk management process satisfies the requirements of Article 51 of the UCITS Directive and is consistently effective. In particular, it shall be able to demonstrate that appropriate safeguards against conflicts of interest have been adopted to allow for an independent performance of the risk management activities.

7. The unit(s), department(s) or personnel in charge of carrying out the risk management tasks (the risk management function) should be specifically identified – at least in terms of the number of persons and their role – in the risk management policy.

8. In order to enable the risk management function to discharge its responsibilities properly, the risk management function should be appropriately resourced, and should operate in accordance with adequate standards of competence and efficiency. It should employ sound processes, professional expertise and adequate techniques and systems.

9. Independence from the operating units is required for the risk management function to operate successfully. In addition, the method of determining the remuneration of the persons involved in the risk management function must not be likely to compromise their objectivity.

10. As stated in CESR's Risk Management Principles for UCITS, 'A separate risk management function serves the purpose to achieve an appropriate level of independence. However, it is necessary to allow flexibility in structuring the risk management framework since it may be disproportionate for a smaller Company to establish a separate risk management function. Where it is not appropriate or proportionate to have a separate risk management function, the Company should nevertheless be able to demonstrate that specific safeguards against conflicts of interest allow for an independent performance of the risk management activities.' CESR would usually expect that, if the value at risk approach or advanced risk measurement methodologies are used to comply with statutory limits on global exposure, management companies should establish a separate risk management function.

11. As outlined below and in the Risk Management Principles for UCITS, the risk management function should:

- carry out an appropriate identification of the material risks relevant to the UCITS, by avoiding over-reliance on single methodologies or specific risk management models (techniques, methods and technical instruments);
- provide advice to the board of directors in relation to the initial definition and subsequent revision of the risk profile of the UCITS;
- provide ongoing monitoring and measurement of risk relevant to the UCITS;
- ensure the UCITS' risk limit system, including statutory limits concerning global exposure and counterparty risk as set out in the UCITS Directive, is complied with (this may be done by the risk management function alone or in conjunction with another independent function such as the compliance function, as determined by the board of directors);
- implement the methods and procedures necessary for the above-mentioned purposes, including the drafting of the related documentation;

- review and, if needed, provide appropriate support concerning the arrangements and procedures adopted for the valuation of assets which involve complex risks such as illiquid assets, structured securities and OTC derivatives;
- report regularly to the board of directors and senior management of the management company.

12. Staff engaged in risk management activities should be compensated in a manner that is independent of the business areas they oversee and commensurate with their role in the management company. In particular, compensation schemes should be appropriate in order to ensure the quality of such employees remains adequate to their tasks and that their authority in the company is not undermined. In addition, compensation of risk management employees should not be influenced by personnel involved in front-line marketing or fund management areas, in such a way that this may compromise their independence.

3. Risk management activities performed by third parties

Box 3

Risk management activities performed by third parties

1. When management companies make arrangements for risk management activities to be performed by third parties, the companies remain fully responsible for discharging all of their obligations under Article 51 of the UCITS Directive. The performance of activities by third parties shall not affect the responsibilities of the board of directors or senior management in respect of risk management.

2. Management companies shall exercise due skill, care and diligence when entering into, managing or terminating any arrangement with third parties in relation to the performance of risk management activities. Management companies shall, in particular, take the necessary steps in order to verify that:

(a) the third party must have the ability and capacity to perform the risk management activities reliably and professionally;

(b) the third party must carry out the risk management activities effectively, and to this end the management company must establish methods for the on-going assessment of the standard of performance of the third party;

(c) the management company must retain the necessary resources and expertise to supervise effectively the risk management activities carried out by third parties and manage the risks associated with the arrangements and must supervise those activities and manage those risks.

3. The performance of risk management activities by third parties shall not prevent the effectiveness of supervision by competent authorities over the adequacy of the risk management process and the compliance with the requirements of the UCITS Directive.

13. The UCITS Directive provides, in Article 12, some general principles concerning the procedural and organisational requirements that the management companies should comply with, but does not set specific conditions on the performance of the risk management function by third parties.

14. CESR considers that management companies should be allowed, for the purposes of efficiency, to make arrangements for the performance of risk management activities (ie calculation of risk measures, production of exception reports, etc) by a third party by written agreement. In medium and small-sized management companies, performance of risk management activities by third parties may serve to enhance the level of independence from the operating unit.

15. The performance of risk management activities by third parties should, however, be subject to

conditions aimed at preserving the quality and effectiveness of the risk management process, oversight of which remains under the full responsibility of the board of directors. In order to ensure appropriate accountability of this oversight process, management companies may appoint one or more members of the board of directors with specific duties and responsibilities concerning the supervision of the risk management activities carried out by third parties.

16. Before entering into the agreement with the third party and on an ongoing basis, the management company should be satisfied that the third party is able to carry out the activities reliably and effectively and in compliance with applicable laws and regulatory requirements, having regard to the characteristics of the management company and of the UCITS it manages. Setting up arrangements for the performance of risk management activities by third parties should always be preceded by appropriate technical due diligence concerning the systems, methods and information used by the third party, including an assessment of any potential conflicts of interest.

17. Appropriate action must be taken if it appears that the third party may not be carrying out the risk management activities effectively and in compliance with applicable laws and regulatory requirements. The management company should be able to terminate the arrangement where necessary without detriment to the continuity and quality of its provision of the collective portfolio management activity. Management companies should in any event take all reasonable steps to ensure continuity to the risk management process in case of interruptions to the risk management activities being performed by third parties (unexpected breaches of the contract, an urgent need to revoke the mandate, major infringements by the third party etc.).

18. It should also be ensured that supervision by competent authorities is not hampered. The third party should co-operate with the relevant competent authorities in connection with the risk management activities. Moreover, the management company, its auditors and the competent authorities should be able to effectively access data related to the risk management activities performed by third parties, as well as, if necessary, to the business premises of the third party. Management companies should make available on request to the competent authorities all information necessary to enable such authorities to supervise the compliance of the performance of the risk management activities with the requirements of the UCITS Directive.

4. Measurement and management of risks

Box 4

Risk measurement and management

1. Management companies shall adopt adequate and effective arrangements, processes and techniques to measure and manage at any time the risks the UCITS they manage are or might be exposed to and to ensure the statutory limits concerning global exposure and counterparty risk in accordance with Boxes 9 and 12 are complied with. Those arrangements, processes and mechanisms shall be proportionate in view of the nature, scale and complexity of the business of the management companies and of the UCITS they manage and be consistent with the UCITS risk profile.

2. For the purposes of paragraph 1, management companies shall be required to take the following actions:

(i) to ensure that, for each UCITS they manage, the risks of the positions and their contribution to the overall risk profile are accurately measured on the basis of sound and reliable data and that the risk measurement arrangements, processes and techniques are adequately documented;

(ii) to conduct, where appropriate, periodic back-tests in order to review the validity of the risk measurement arrangements which include model-based forecasts and estimates;

(iii) to conduct, where appropriate, periodic stress tests and scenario analyses to address risks arising from potential changes in market conditions that could adversely impact the UCITS;

(iv) to establish, implement and maintain, for each UCITS they manage, a documented system of limits concerning the measures used to manage and control the relevant risks. The risk limit system shall have regard to all risks material to the UCITS as identified in Box 1 and shall be consistent with the UCITS risk-profile;

(v) to ensure that the current level of risks complies with the risk limit system for each UCITS;

(vi) to establish, implement and maintain adequate procedures that, in the event of actual or anticipated breaches to the risk limit system of the UCITS, result in timely remedial actions in the best interests of unit-holders.

3. Management companies shall employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to comply at any time with Article 84(1) of the UCITS Directive. Where appropriate, management companies shall conduct stress tests which enable to assess the liquidity risk of the UCITS under exceptional circumstances.

4. Management companies shall ensure that for each UCITS they manage the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules or instruments of incorporation or prospectus.

19. Strengthening risk management systems and procedures and setting out a common approach to risk management is crucial to maintaining mutual confidence and delivering high standards of investor protection throughout the EU.

20. The requirements proposed in Box 4 concerning risk measurement and management are in line with CESR's Risk Management Principles for UCITS. CESR proposes that they be complemented by specific requirements concerning risk measurement methods as elaborated in Boxes 10 and 11.

21. The risk management process, the functioning and organisational rules of which should be established as part of the organisational rules adopted by the management company, should be adequate and proportionate to the nature, scale and complexity of the company's activities and of the UCITS it manages. It should allow adequate assessment of the concentration and interaction of relevant risks at the portfolio level.

22. Management companies should employ proportionate and effective risk measurement techniques, which include both quantitative measures, as regards quantifiable risks, and qualitative methods, as elaborated in the Risk Management Principles for UCITS. IT systems and tools used for the computation of quantitative measures should be integrated with one another or with the front-office and accounting applications. Risk measurement techniques should allow for an adequate measurement of risks in periods of increased market turbulence and be reviewed whenever necessary in the interest of unit-holders.

23. If the UCITS invests in structured financial instruments, the risks associated with any of the components should be appropriately identified and managed. Investment in structured financial instruments should be preceded by appropriate due diligence concerning the characteristics of the underlying assets and the overall risk profile of the instruments.

24. Management companies should deal appropriately with the possible vulnerability of their risk measurement techniques and models by carrying out, where appropriate, stress tests, back tests and scenario analyses, as indicated in the Risk Management Principles for UCITS. In particular, stress tests, back tests and scenario analyses should always be carried on an on-going basis when the management companies adopt the value at risk approach or advanced risk measurement methodologies for the computation of the global exposure as indicated in Box 11. Where stress tests and scenario analyses reveal particular vulnerability to a given set of circumstances, prompt steps and corrective actions shall be taken to manage those risks appropriately.

25. A documented limit system to manage and control risks should be defined for each UCITS. The risk limit system – which should be complied with as part of the ongoing risk management process – should cover all risks to which a limit can be applied and should take into account their interactions with one another. Every transaction should be taken into account in the calculation of the corresponding limits. Management companies should record cases in which the limits are exceeded and the actions taken.

26. In order to ensure an adequate level of investor protection and constant awareness of the risks relevant to the UCITS, management companies shall measure and monitor on an ongoing basis the counterparty risks attached to over-the-counter transactions (including also stock lending transactions).

27. The UCITS' internal risk limits system described above should properly take into account also the risks arising from the concentration of investments towards the same entity, or towards entities belonging to the same group, having regard to the creditworthiness of such individual or group counterparties.

28. As elaborated in the Risk Management Principles for UCITS, management companies should define in their risk management policies procedures that, in the event of actual or anticipated breaches of the risk limit system of the UCITS, result in timely remedial actions.

29. Moreover, the present advice proposes specific requirements for the management of the liquidity risk, in order to ensure that the UCITS remains able to meet the obligation to re-purchase or redeem its units at the request of any unit-holder imposed by Article 84 of the UCITS Directive. In particular, for each UCITS they manage, management companies should adopt procedures which ensure that the liquidity risk is appropriately assessed, managed and monitored overtime. The safeguards and limits adopted as part of the liquidity risk management process should be proportionate to the risk profile of the UCITS and should also take into account the impact of temporary leverage. They should ensure on an ongoing and forward-looking basis that the liquidity profile of the portfolio, as resulting from the contribution of each single investment, allows the UCITS redemption policy to be applied.

30. Management companies should have in place, where appropriate and proportionate, contingency plans to deal with liquidity crises. Those plans should take into account the outcomes of the stress tests and scenario analyses which management companies should perform, where appropriate, for the purposes of liquidity risk management. The processes for the measurement and management of the liquidity risk should be reviewed regularly.

5. Responsibility of the board of directors and internal reporting

Box 5

Responsibility of the board of directors and internal reporting

1. Management companies shall assess, monitor and periodically review:

(i) the adequacy and effectiveness of the risk management policy and of the arrangements, processes and techniques referred to in Box 4;

(ii) the level of compliance by the management company with the risk management policy and with those arrangements, processes and techniques;

(iii) the adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process.

2. Management companies, when allocating functions internally, shall ensure that the board of directors is responsible for ensuring that the management company complies with its obligations under Article 51 of the UCITS Directive.

3. The board of directors shall be required to approve and periodically review the risk management policy and its implementing arrangements, processes and techniques, including the risk limit system of each UCITS.

4. Management companies shall ensure that their board of directors and the supervisory function if any receive periodic written reports on:

(i) the consistency between the current level of risk incurred by each UCITS and its risk-profile;
(ii) the compliance of the management of each UCITS with the relevant risk limit system;
(iii) the adequacy and effectiveness of the risk management process, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies.

5. Management companies shall ensure that senior management receives regular reports from the risk management function outlining the current level of risk incurred by the UCITS and any actual or foreseeable breaches to their limits to ensure prompt and appropriate action is taken.

6. The risk management policy shall identify the allocation of responsibilities within the management company pertaining to risk management and define the terms, contents and frequency of the reporting of the risk management function to the board of directors and to senior management and, where appropriate, to the supervisory function.

31. The proposals in Box 5 are consistent with the principles dealing with monitoring of the risk management process and internal reporting already contained in CESR's Risk Management Principles for UCITS.

32. The board of directors should be responsible for, and be actively involved in the control of, the adequacy and effectiveness of the risk management process and should regard this as an essential aspect of the business to which adequate resources need to be devoted. In particular, the board of directors should approve the risk management policy, the UCITS' risk profile and risk limit system for each UCITS managed by the management company. As stated in the Risk Management Principles for UCITS, it should ensure that all aspects of the risk management process, including the risk management function itself, are subject to appropriate review. It should take appropriate action in the best interest of unit-holders in the cases of evidence that the actual level of risk incurred by the UCITS is not consistent with its target risk profile.

33. The board of directors should set out arrangements suitable to foster a robust and pervasive risk management culture within the management company. For this purpose, management companies should consider adopting appropriate remuneration policies for both the risk management and the investment management functions designed to reward the achievement of the risk management policy.

34. The terms, contents and frequency of reporting by the risk management function to the board of directors and senior management should be defined by the risk management policy. The level of detail provided should be tailored to the needs of the recipients, while ensuring that they have an adequate overall presentation of information necessary to discharge their respective responsibilities. For example, reports to the board of directors should be focused on providing a periodic assessment of the appropriateness and effectiveness of the overall risk management policy and process. Reports to senior management should focus more on the prevention and correction of breaches to the risk limit system. Reports by the risk management function should be delivered directly to the board of directors and senior management.

6. Procedures for the valuation of OTC derivatives

Box 6

Procedures for the valuation of over-the-counter (OTC) derivatives

1. Management companies should verify that UCITS exposures to OTC derivatives are assigned fair values that do not rely only on market quotations by the counterparties of the OTC transactions and which fulfil the following criteria:

(i) the basis for the valuation is either a reliable up-to-date market value of the OTC instrument, or if such value is not available, a pricing model using an adequate recognised methodology;
(ii) verification of the valuation is carried out by one of the following:

a) an appropriate third party which is independent from the counterparty of the OTC-derivative, at an adequate frequency and in such a way that the management company is able to check the verification process;
b) a unit within the management company which is independent from the department in charge of managing the assets and which is adequately equipped for such purpose.

2. For the purposes of paragraph 1, management companies should establish, implement and maintain arrangements and procedures which ensure appropriate, transparent and fair valuation of UCITS exposures to over-the-counter (OTC) derivatives. Management companies should comply with the requirements set out in Box 3 when arrangements and procedures concerning the valuation of OTC derivatives involve the performance of certain activities by third parties. Valuation arrangements and procedures should be adequate and proportionate to the nature and complexity of the OTC derivatives concerned.

3. Management companies should ensure that the fair value of OTC derivatives described in paragraph 1 is subject to adequate, accurate and independent assessment. The risk management function should be appointed with specific duties and responsibilities for this purpose; in all cases, the risk management function should review and, if needed, provide appropriate support concerning the arrangements and procedures adopted for the valuation of OTC derivatives and of other asset types which involve complex risks, such as illiquid investments and structured securities.

4. The valuation procedures and arrangements described in paragraph 2 should be adequately documented and formalised.

5. The requirements set out in this box should apply also to other types of financial instrument which expose the UCITS to valuation risks equivalent to those of OTC derivatives.

35. Article 51(1) of the UCITS Directive requires that the value of UCITS' exposures to OTC derivatives be subject to accurate and independent assessment.

36. With respect to the accuracy requirement, management companies should adopt adequate arrangements so as to ensure that the valuation of UCITS exposures to OTC derivatives is carried out according to fair pricing principles. In particular, valuations of OTC derivatives should reflect, where appropriate, the reliable up-to-date market values of such instruments, as possibly expressed also by the prices of comparable trades. However, when the valuation of OTC derivatives requires the use of specific models and techniques, the management company shall assess that the theoretical basis and hypotheses implemented by such models appropriately take into account of all the characteristics of the OTC instruments. These valuation models should be maintained and revised over time according to the principles described in Box 4 (using back-testing etc.).

37. In any case, the prices obtained via models should correspond to the probable trading values of the OTC derivatives. In this respect, accurate assessment shall imply the verification that, if prices or quotes are available from the counterparties of the OTC derivatives, or by external contributors, these are compared with the prices calculated using the models and that, in the event of relevant divergences, the differences are appropriately documented, explained and promptly disclosed to the management company.

38. Furthermore, when valuation of OTC derivatives is carried out through model-based techniques, the market data used to calibrate such models should be adequate to reflect the market realities at all times; data should therefore be kept updated at adequate intervals. As a consequence, when the data is not directly observable (such as certain implicit correlations or certain credit spreads) or is not representative of the market conditions, the third delegated entity or the unit within the management company appointed to carry out the valuation should be able to compute the value of the OTC derivatives on the basis of reasonable and coherent estimates of the relevant data, adjusting the available data if necessary.

39. As regards the organisational requirements, the assessment of the OTC derivatives valuation should be carried out by a department independent from the commercial or operational units of the management company, or, if these conditions cannot be fulfilled, by a third entity independent from the counterparties of the OTC transactions. In the latter case, however, the management company will remain responsible for the correct valuation of the OTC derivatives and will have to verify that the independent third party can adequately value the types of OTC derivative that it wishes to purchase or underwrite.

40. Management companies should verify that the principle of independent assessment concerning the valuation of OTC derivatives is fully complied with also in performance of such valuation procedures by third parties.

41. While management companies can in general use their own valuation systems, the independence requirement excludes the possibility of relying upon valuation models that, although proprietary, (such as those used by the dealing room that concludes the OTC derivatives) have not been subject to independent revision within the company or by third parties. This principle also excludes the use of data (such as volatility or correlations) produced by a process which has not been qualified by the management company.

42. CESR believes that, without prejudice to the differences between the objectives pursued by the risk management and the valuation processes, there should be sufficient interaction between

the two functions (risk management and valuation) so as to allow mutual support, where necessary. Indeed, interaction between the two functions is needed to ensure consistency between the models used for pricing of assets that require complex evaluation (such as illiquid assets, structured financial instruments – whether or not they embed derivatives – or OTC derivatives), and the measurement framework used for risk management purposes. In all cases, the risk management function should review and, if needed, provide appropriate support concerning the arrangements and procedures adopted for the valuation of those assets; however, it should not impose its pricing assumptions and models on the valuation function.

43. CESR believes that, in most cases, the risk management function may be particularly suited to the responsibility of carrying out the verification of the valuation of OTC derivatives pursuant to Box 6, para. 1(II)(b). The risk management function should be equipped with the appropriate skills and resources needed to tackle the complex issues relating to the valuation of OTC derivatives and, furthermore, should be afforded the required level of independence within the organisation of the company.

44. Accurate assessment of the valuation arrangements for OTC derivatives and procedures should imply the performance of ongoing checks. The frequency of these controls should be adequate and proportionate having regard to: the complexity of the financial instruments concerned, the NAV computation and redemption periodicity of the UCITS, and the organisational features of the valuation arrangements and procedures.

45. Management companies should ensure that the principles set out in Box 6 are applied consistently to the valuation of other types of financial instrument which are subject to the same difficulties and specificities that affect the valuation of OTC derivatives, such as those relating to product illiquidity and/or complexity of the pay-off structure. In this respect, management companies wishing to secure compliance with independent fair pricing principles should deem appropriate to adopt arrangements and procedures consistent with the requirements set out in Box 6 also for the valuation of poorly liquid or complex transferable securities and money market instruments which require the use of model-based valuation methods.

7. Supervision

Box 7

Supervision

1. The competent authorities shall review the adequacy and effectiveness of the risk management process adopted by the management company when granting the authorisation for the access to the business of management companies under Article 6 of the UCITS Directive.

2. When authorising a new UCITS under Article 5 of the UCITS Directive, the competent authorities shall be satisfied that the risk management process remains adequate and effective, having regard to the risks to which the UCITS they manage are or might be exposed.

3. The competent authorities shall review the adequacy and effectiveness of the risk management process adopted by the management company on an on-going basis. For these purposes, management companies shall notify material changes to the risk management process to the competent authorities to ensure they have an opportunity to intervene in appropriate cases.

4. Competent authorities shall require any management company that does not meet the requirements on risk management to take the necessary actions or steps at an early stage to address the situation.

46. It is proposed that the adequacy and effectiveness of the risk management process should be considered by the competent authorities as part of the process for authorising the management company. This includes an assessment of the techniques, procedures and arrangements used by the management company to identify, measure, manage and monitor the risks relevant to the UCITS in accordance with the applicable laws and regulations. In particular, as part of their assessment, competent authorities should consider the appropriateness of the methodologies and procedures adopted by the management company to comply with the statutory limits on global exposure and counterparty risk.

47. Moreover, when authorising a new UCITS, the competent authorities should check and be satisfied that the risk management process remains adequate and effective having regard to the characteristics (such as the risk profile and investment strategy) and degree of complexity of the new fund to be managed. For these purposes, the competent authorities may take into account the appraisal carried out at the time of authorising the management company and/or at subsequent changes of the risk management process.

    As stated in CESR's Risk Management Principles for UCITS, competent authorities should supervise the adequacy and effectiveness of the risk management process on an ongoing basis. They should be notified of material changes to the risk management process to enable them to intervene in appropriate cases.

Box 8

Investment companies

1. Boxes 1 to 7 shall apply mutatis mutandis to investment companies that have not designated a management company authorised pursuant to the UCITS Directive.

2. For the purpose of these Boxes, 'management company' shall be construed as 'investment company'.

48. Boxes 1 to 7 should always be complied with by authorised investment companies, either by the company directly in accordance with those Boxes or indirectly, due to the fact that if an authorised investment company chooses to designate a management company, that management company should be obliged to comply with those Boxes.

CHAPTER II

REQUIREMENTS CONCERNING RISK MEASUREMENT METHODS

8. Risk Measurement and Global Exposure

Box 9

Global Exposure

1. Global exposure, as referred to in Article 51(3) of the UCITS Directive, is a measure designed to limit either the incremental exposure and leverage generated by a UCITS through the use of financial derivative instruments (including embedded derivatives) or the market risk of the UCITS portfolio.

2. Counterparty risk arising from an over-the-counter (OTC) financial derivative instrument is captured by the application of the specific limits set out in Article 52 of the UCITS Directive.

3. Where a UCITS, in accordance with Article 51(2) of the UCITS Directive, employs techniques and instruments (other than financial derivative instruments) including repurchase transactions or securities lending transactions, in order to generate additional leverage and market risk through, for example, the reinvestment of collateral, these transactions must also be taken into consideration in the determination of global exposure.

4. A UCITS global exposure must be calculated on at least a daily basis.

5. A UCITS global exposure may be calculated using the commitment approach, the value at risk approach or advanced risk measurement methodologies recognised by CESR.

6. UCITS must ensure that the method selected to measure global exposure is appropriate taking into account the investment strategy being pursued and the types and complexity of the financial derivative instruments used. The UCITS should also consider the proportion of the portfolio comprising financial derivative instruments.

Explanatory Text

49. The definition of global exposure depends on the calculation methodology chosen by the UCITS. The commitment approach measures the incremental exposure and leverage generated through the use of derivatives. Advanced risk measurement techniques such as value at risk (VaR) measure the market risk of the whole portfolio.

50. The calculation of global exposure represents one element of the UCITS overall risk management process. The risk management process shall comprise procedures which enable the management company to assess the UCITS exposure to all material risks including market

risks, liquidity risks, counterparty risks and operational risks.

51. Given that the counterparty risk associated with OTC financial derivative instruments is specifically limited for a given entity through the provisions of Article 52(1) of the UCITS Directive and dealt with separately in this paper, global exposure is reduced to its market risk dimension.

52. If UCITS are authorised to avail of repurchase transactions or securities lending transactions in order to generate additional leverage and market risk through, for example the reinvestment of collateral, these transactions must be taken into consideration in the determination of the global exposure.

53. A UCITS must comply with the global exposure limits on a continuous basis. The majority of respondents to the consultation supported the proposal to calculate VaR on at least a daily basis. It is therefore deemed appropriate to require the calculation of global exposure for all methods, including the commitment approach, to be carried out on at least a daily basis. It should be noted that OTC financial derivative instruments are also subject to daily valuation procedures and controls.

54. In order to ensure that there is a harmonised approach to the methodologies used to calculate global exposure, only those advanced risk measurement approaches which have been recognised by CESR can be used by UCITS to calculate global exposure. CESR will bring the guidelines which will accompany the implementing measures into effect as a single package and in parallel with the deadline of 1 July 2010 for adoption by the Commission of the level 2 measures. The recitals to the Implementing Directive should recommend that CESR issue guidance on the conditions to be applied to the different methods for calculating global exposure. The European Commission should also consider amendments to the UCITS Directive to make provision for binding CESR guidelines in this area under the proposed new regulatory structure.

55. CESR recommends that the distinction between sophisticated and non-sophisticated UCITS as referred to in the Commission Recommendation is no longer appropriate. No common definition is used by Member States and this has resulted in confusion among industry participants (including investors). The decision regarding the methodology chosen to calculate global exposure is a matter for the UCITS. In making this decision UCITS should consider the types and complexity of the derivatives used and their impact on the UCITS overall strategy.

Box 10

Commitment Approach

1. The calculation process when using the commitment approach must be applied to all financial derivative positions (including embedded derivatives), whether used as part of the UCITS' general investment policy, risk reduction and/or for the purposes of efficient portfolio management purposes as described in Article 51(2) of the UCITS Directive.

2. The standard commitment approach calculation converts the financial derivative position into the market value of an equivalent position in the underlying asset of that derivative. Under the commitment approach, a UCITS may apply other calculation methods to financial derivative positions equivalent to the standard commitment approach.

3. When calculating global exposure using the commitment approach, a UCITS may benefit from the effects of netting and hedging arrangements. Additionally, where the use of financial derivative instruments does not generate incremental exposure for the UCITS the underlying exposure is not included in the commitment calculation. Netting and hedging arrangements may only reduce global exposure provided they do not ignore obvious or material risks, result in a clear reduction in such risks and comply with the criteria agreed by CESR members.

4. When using the commitment approach, temporary borrowing arrangements entered into by the UCITS in accordance with Article 83 of the UCITS Directive do not form part of the global exposure calculation.

Explanatory Text

56. Article 50(1)(g) of the UCITS Directive permits a UCITS to invest in financial derivative instruments subject to certain conditions. Article 51(2) permits a UCITS to employ techniques and instruments (including financial derivative instruments) for the purposes of efficient portfolio management purposes. Paragraph 1 clarifies that all derivatives must be included in the calculation of global exposure whether used as part of the UCITS' investment policy, for efficient portfolio management and/or risk reduction purposes.

57. In calculating global exposure using the commitment approach UCITS should convert the positions in financial derivative instruments into the equivalent position in the underlying assets by taking the market value of the underlying asset or, if appropriate and conservative, the notional of the financial derivative instrument. In cases where conversion of the financial derivative position into the equivalent position in the underlying asset or the notional does not provide for an adequate and accurate assessment of the risks relating to the instrument, the UCITS should use other calculation methods equivalent to the standard commitment approach. The recitals to the Implementing Directive should recommend that CESR issue guidance on the conversion method to be used for specific types of financial derivative instruments when calculating global exposure using the commitment approach.

58. The recitals to the Implementing Directive should also recommend that CESR issue guidance on the criteria to be used in assessing whether netting or hedging arrangements may be used to reduce global exposure using the commitment approach. The European Commission should also consider amendments to the UCITS Directive to make provision for binding CESR guidelines in this area under the proposed new regulatory structure.

Box 11

Value at Risk and advanced risk measurement methodologies

1. Value at risk and advanced risk measurement methodologies should comply with quantitative and qualitative requirements including, stress testing and back testing which will be agreed by CESR members

Explanatory Text

59. In order to ensure a harmonised approach to the calculation of global exposure using the VaR approach, the recitals to the Implementing Directive should recommend that CESR issue guidance on the limits used to calculate VaR including the maximum permitted VaR, the minimum observation period used and the use of stress testing and back testing. CESR will bring the guidelines which will accompany the implementing measures into effect as a single package and in parallel with the deadline of 1 July2010 for adoption by the Commission of the level 2 measures. The European Commission should also consider amendments to the UCITS Directive to make provision for binding CESR guidelines in this area under the proposed new regulatory structure.

Box 12

Counterparty Risk/Issuer Concentration

1. A UCITS' risk exposure to a counterparty arising from OTC derivative transactions, as referred to in Article 52(1) of the UCITS Directive, should be calculated using the positive mark to market value of the OTC derivative contracts with that counterparty.

2. When calculating risk exposure to a counterparty in accordance with the limits in Article 52(1) of the UCITS Directive, a UCITS may net derivative positions with the same counterparty provided there are legally enforceable netting arrangements in place.

3. A UCITS may reduce its risk exposure to a counterparty to an OTC derivative transaction through the receipt of collateral. Collateral received must be sufficiently liquid in order that it can be sold quickly by the UCITS at a price that is close to its pre-sale valuation. Collateral must also comply with the principles agreed by CESR members.

4. Where a UCITS passes collateral to an OTC derivative counterparty, this must be taken into account in calculating the counterparty risk exposure as referred to in Article 52(1) of the

UCITS Directive. Collateral passed may be taken into account on a net basis (i.e. over collateralization) where there is a legally enforceable netting arrangement in place.

5. The issuer concentration limits as set out in Article 52 of the UCITS Directive on underlying exposure arising from the use of financial derivative instruments must be calculated using the commitment approach where appropriate.

6. Exposure arising from OTC derivative transactions as referred to in Article 52(2)(c) of the UCITS Directive includes any OTC derivative counterparty risk exposure.

Explanatory Text

60. OTC counterparty risk exposure measures how much a UCITS could lose if the counterparty to an OTC derivative transaction defaults. The additional safeguards required by the UCITS Directive that mitigate this risk exposure (including daily valuation of OTC derivative instruments, independent verification of such valuations, the requirement that OTC derivative instruments are fully liquid and restrictions on types of eligible counterparty) should be taken into account in determining an appropriate methodology for calculating counterparty risk exposure across all Member States.

61. The UCITS Directive does not set any limits on counterparty risk in relation to techniques and instruments (other than financial derivative instruments) including repurchase transactions or securities lending transactions. This represents a risk to UCITS which is not captured by any diversification limits although counterparty risk must be assessed as part of the overall risk management process. It is recommended that the European Commission examine this issue and consider amendments to the UCITS Directive to make provision for binding CESR guidelines in this area under the proposed new regulatory structure.

62. Due to the existence of these compensating controls and requirements in the UCITS Directive, CESR considers that the "add-on" for future credit exposure is not necessary as this inflates the risk exposure in a subjective manner. CESR also proposes that the use of risk-weightings should not be permitted. This approach greatly simplifies the calculation of counterparty risk while also recognising that the amount calculated represents the full current amount at risk. It is recommended, therefore, that the counterparty risk associated with the use of OTC derivatives should be calculated as the positive mark to market value of the OTC derivative contract.

63. It is recommended that netting positions with the same OTC counterparty be permitted provided legally enforceable (by the UCITS) netting agreements are in place. It should also be understood that the netting rules are only applicable to OTC derivative instruments with the same counterparty and not to any other exposures the UCITS may have to the counterparty.

64. A UCITS may receive collateral to reduce counterparty risk provided the collateral is sufficiently liquid, exposed to negligible risks and fully enforceable by the UCITS at any time. The recital to the Implementing Directive should recommend that CESR issue guidance on a detailed set of regulatory principles to be applied to any such collateral arrangements. The European Commission should also consider amendments to the UCITS Directive to make provision for binding CESR guidelines in this area under the proposed new regulatory structure.

65. Market practice may require collateral or margin to be passed by the UCITS to an OTC counterparty or broker in respect of OTC financial derivative transactions. This collateral represents a portion of the assets of the UCITS legally passing from the UCITS depository to the derivative counterparty (although the UCITS still bears the market and credit risks associated with such collateral). It is clear that an exposure is created that represents a risk of loss to the UCITS (i.e. the loss of the collateral in the event of, say, a bankruptcy). Collateral passed should be captured as part of the 5%/10% OTC derivative counterparty limit on a gross basis, but may be permitted on a net basis (i.e. in the case of over-collateralisation) only where a legally enforceable (by the UCITS) netting arrangement is in place.

66. In accordance with Article 51(3) of the UCITS Directive a UCITS may invest in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits laid down in Article 52. These issuer concentration limits as set out in Article 52 of the UCITS Directive (i.e. 5%/10%/40% limits) on underlying exposure arising from the use of financial derivative instruments must be calculated using the commitment approach.

Section V
CESR's technical advice to the European Commission on the implementing measures on supervisory co-operation (Articles 101 and 105 of the UCITS Directive)

INTRODUCTION

Background

1. The Commission's mandate requests CESR to advise, inter alia, on possible implementing measures concerning the procedures for on-the-spot verifications and investigations (Article 101 of the UCITS Directive) and the procedures for exchange of information between competent authorities (Article 105 of the UCITS Directive).

2. CESR was invited to provide its technical advice by 30 October 2009 at the latest.

CESR is invited:

1. To define the content of the procedures to be followed when competent authorities intend to carryout verification or an investigation on the territory of another Member State;

2. To define the content of the procedure to be followed when competent authorities intend to exchange information;

3. To indicate whether there are areas which could be more effectively regulated at level 3.

General approach

3. Considering that similar provisions and implementing powers exist in other financial services directives, in particular MiFID and the Market Abuse Directive, the European Commission has invited CESR to take into account its previous work done in this area in order to avoid duplication of procedures and achieve a maximum level of coherence across the different areas of financial services[25].

4. On this basis, in giving this advice, CESR has taken into account the existing legal framework concerning the provision of international co-operation, as well as the best practices developed by CESR and IOSCO, including the CESR Multilateral Memorandum of Understanding, the practice developed within CESR-Pol, the IOSCO Multilateral MoU, the IOSCO recommended practices for information-sharing and co-operation and the IOSCO guide on Joint Cross-border investigations and related proceedings of February 2009.

5. CESR is invited to avoid imposing procedures which might be considered too bureaucratic on Member States, such that they would effectively render cross-border verifications and investigations less efficient.

6. CESR has also paid close consideration to the need to reduce supervisory costs and duplications and avoid unnecessary burdens on the investigated entities. CESR believes that appropriate co-ordination between the investigating authorities is essential to this purpose, without prejudice to the overarching principle of ensuring a high level of investor protection.

[25] See the pages 14 and 15 of the Commission's mandate.

DEFINITIONS

'UCITS Directive' means the Directive on undertakings for collective investment in transferable securities adopted by the Council on 22 June 2009, following a first-reading agreement with the European Parliament (position of the European Parliament adopted on 13 January 2009).

'MiFID' means Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments.

'CESR MMoU' means the CESR Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities (CESR/05-355).

CHAPTER 1

ON-THE-SPOT VERIFICATIONS AND INVESTIGATIONS

Implementation of Article 101(9) of the UCITS Directive

Introduction

1. Strong co-operation among competent authorities is necessary to ensure compliance with the UCITS Directive and the smooth functioning of the internal market and in order to ensure the protection of investors.

2. Article 101(1) of the UCITS Directive provides that 'the competent authorities of the Member States shall co-operate with each other whenever necessary for the purpose of carrying out their duties under this Directive or of exercising their powers under this Directive or under national law'. To this end Member States are requested to take all necessary administrative and organisational measures to facilitate the co-operation provided for in the Directive.

3. Moreover, as for other financial sector directives, the new text clarifies that 'competent authorities shall use their powers for the purpose of co-operation, even in cases where the conduct under investigation does not constitute an infringement of any regulation in force in that Member State'.

4. From the reading of the above provisions, it is clear that a competent authority has the right to request co-operation for all the matters falling within its remit, pursuant to the national implementation of the directive. The requested authority should be able to provide assistance even if in its jurisdiction the relevant behaviour is not deemed to be an infringement. It should also be recalled that pursuant to Article 98 of the UCITS Directive, the competent authorities must be able to exercise a minimum list of powers for supervisory or enforcement purposes that should also be available in order to provide assistance to a competent authority of another Member State.

5. Moreover, Article 101(4) of the UCITS Directive provides that the competent authorities of one Member State may request the co-operation of the competent authorities of another Member State in a supervisory activity or for an on-the spot verification or in an investigation on the territory of the latter within the framework of their powers pursuant to the Directive. The requested competent authority should: (a) carry out the verification or investigation itself; (b) allow the requesting authority to carry out the verification or investigation; or (c) allow auditors or experts to carry out the verification or investigation.

6. Article 101(5) of the UCITS Directive provides in general terms the modalities according to which an on-site inspection can be performed in another Member State and the authorities taking part in it.

7. The Commission is empowered to adopt detailed implementing measures concerning procedures for on-the-spot verifications and investigations (Article 101(9) of the UCITS Directive).

8. CESR should define the content of the procedures to be followed when competent authorities intend to carry-out the above-mentioned verifications or investigations on the territory of another Member State.

9. It is understood, on the basis of the above provisions, that when a competent authority wishes to perform an on-site inspection of a person or an entity in another Member state for supervisory or for

enforcement purposes under the UCITS Directive, it should request the assistance of the competent authority of such Member State and the requested authority should provide the necessary co-operation. The possibility to perform an on-site inspection on the territory of the requested authority encompasses, but is not limited to, the right to inspect branches. It cannot be ruled out that for enforcement purposes there is the need to inspect an entity or a person located in another jurisdiction.

Level 2 advice

Box 1

Request for assistance in connection with on-the-spot verification and investigation

1. Competent authorities wishing to carry out on-the spot verifications or investigations on the territory of another Member State should comply with the following procedure:

a) The requesting authority should submit a request to the other authority informing of its need to carry out on-the-spot verifications or investigations in the territory of the latter, providing details on:

- the background of the request, including the legal provisions applicable in the jurisdiction of the requesting authority on which the request is based;
- the scope of the verification or the investigation which could be of a general supervisory nature or for specific issues;
- the actions already undertaken by the requesting authority;
- the actions expected from the requested authority to be taken;
- the relevant proposed modalities, and
- why it considers them necessary.

The requesting authority should make available any information that the requested authority demands in order to enable the latter to provide the necessary assistance.

The request should be submitted in writing and reasonably in advance for the requested authority to consider it.

In case of urgency the request may be transmitted by e-mail and discussed orally, provided that it is subsequently formally confirmed.

The competent authority which receives the request should acknowledge receipt as soon as practicable.

b) In order to avoid duplications and unnecessary burdens, the requested authority should transmit without delay the information and documents internally available that may be relevant or useful to the requesting authority, in light of the provided background and scope of the verification or the investigation.

c) The requesting and requested authorities should consult one another in order to consider whether, having due regard to the documents and information transmitted, the on-the-spot verification or investigation is no longer necessary. The authorities should also discuss any relevant issue pertaining to the costs of the on-the spot verification where appropriate.

d) Except for the situations set out in Article 101(6) of the UCITS Directive, in all cases if the requesting authority believes that the on-site inspection is necessary to perform its duties under the directive in accordance with the legal provisions applicable in its jurisdiction it should have the right to proceed.

2. It is up to the requested authority to decide whether it will carry out the on-the-spot investigation directly or whether it will allow staff of the requesting authority or auditors to perform it.

3. Issues related to the allocations of costs should be dealt with bilaterally by the concerned competent authorities.

Box 2

Carrying out of the on-the-spot verification and investigation

A. On-the-spot verification carried out by the requested authority

1. Unless otherwise agreed upon between the authorities, the performance of the verification or investigation is carried out by the personnel of the requested authority in accordance with the procedure provided for in the legislation applicable in the requested jurisdiction.

2. The requested competent authority shall make its best efforts to take account of the relevant importance placed by the requesting competent authority upon the on-the-spot verification or investigation.

3. The requesting authority, whenever it deems it necessary, may request that its staff accompany the personnel of the requested authority.

The requesting and requesting authorities should consult one another to define the modalities of such participation.

In all cases, the requested authority shall maintain the overall control of the on-the-spot verification or investigation.

B. On-the-spot verification carried out by the requesting authority

1. The authorities may agree that the on-the-spot verification or the investigation is carried out directly by the requesting authority in the territory of the requested authority.

2. The requested authority should provide its assistance in order to facilitate the performance of the on-the-spot verification or investigation by the requesting authority.

3. When in performing its verification or investigation the requesting authority discovers material information relevant for the discharging of the requested authority's duties, it should transmit promptly to the requested authority any such information.

C. On-the-spot verification carried out by auditors/experts

1. The authorities may agree to allow auditors or experts to carry out on-the-spot verification or investigation. The requested authority should provide its assistance in order to facilitate the performance of the tasks assigned to the auditors.

2. To this purpose, whenever the requesting authority wishes to propose the appointment of the auditors or experts, it should transmit to the requested authorities any relevant information on the identity and professional qualifications of such auditors or experts. The requested authority should promptly notify the requesting authority whether it accepts the proposed appointment. In case the requested authority does not accept the proposed appointment or the requesting authority does not advance any proposal, the requested authority should have the right to propose itself the identity of the auditors or experts. If the authorities do not achieve an agreement on the appointment, the requested

authority should nonetheless be available to provide its assistance to the requesting authority pursuant to one of the two remaining modalities described under points A. and B. above. Unless otherwise agreed, the authority appointing the auditor or experts should bear the relevant costs.

3. Paragraph B.3 above applies to the auditors or experts appointed by the requesting authority mutatis mutandis.

Box 3

Requests for assistance in connection with the need to acquire information from persons located in the jurisdiction of the requested authority

1. The requesting authority may deem necessary to proceed to a hearing of persons located within the territory of the requested authority. In such a case the procedure described under 1 and 2 of Box 1 above will be followed.

2. The requesting authority should have the right to take part in the hearing and to indicate questions to be raised before and during the hearings.

Explanatory text

1. In general terms, as indicated above, the competent authority may need to exercise its investigation and enforcement powers vis-à-vis persons or entities established in the territory of the requested authority. Provided that the action requested falls within the remit of the requesting authority for the purposes of implementation of the UCITS Directive, the co-operation should be provided.

2. As indicated in the Commission's mandate, the possibility to carry out on-the-spot verifications and investigations in another Member State is certainly essential from the perspective of a well-functioning management company passport.

3. In particular:

    a. the competent authority of the UCITS' home Member State should be able to carry out cross-border verifications or investigations of the management company established in the territory of another Member State to supervise compliance by such management company with respect to the matters falling within the scope of its own responsibilities pursuant to Article 19(3)(4)(5) of the UCITS Directive [26];

[26] According to Article 19(3)(4)(5) of the UCITS Directive, the UCITS' home competent authority is responsible for supervising compliance with the obligations set out in the fund rules (or instrument of incorporation) and in the prospectus. It is also responsible for supervising compliance with the rules which relate to the constitution and functioning of the UCITS, which are namely the rules applicable to:
(a) the set up and authorisation of the UCITS;
(b) the issuance and redemption of units and shares ;
(c) investment policies and limits, including calculation of total exposure and leverage;
(d) restrictions on borrowing, lending and uncovered sales;
(e) the valuation of assets and the accounting of the UCITS;
(f) the calculation of the issue price and/or redemption price, and rules regarding errors in the calculation of the net asset value and the related investor compensation;
(g) the distribution or reinvestment of the income;
(h) the disclosure and reporting requirements of the UCITS, including the prospectus, the key investor information and periodic reports;
(i) the arrangements made for marketing;
(j) the relationship with unit holders;
(k) the merging and restructuring of UCITS;

b. the competent authority of the management company's home Member State should be able to request the co-operation of the UCITS' competent authority for on-the-spot verifications and investigations necessary to verify compliance with the matters falling within its remit of competence according to Article 19(1)(2) of the UCITS Directive[27];

c. in the case of establishment of a branch, the competent authority of the management company's home Member State should be able to carry out an on-the-spot verification in the Member State where the branch is established according to Article 110 of the UCITS Directive.

4. Moreover, as outlined in CESR's advice on the UCITS Management Company Passport, the management company competent authority should be able to request the co-operation of the depositary competent authority (or the UCITS competent authority) to carry out on-the-spot verifications or investigations on the depositary with respect to the supervision of the management company.

5. The new implementing provisions are, however, not restricted to situation where a management company exercises its right to manage a UCITS on a cross-border basis. As indicated above, the co-operation may be necessary to assist in investigations and supervisory activities carried out by the requesting authority for possible infringement of the regulations it administer.

6. Any practical co-operation arrangements should be based on the principles of efficiency, effectiveness and transparency.

7. Boxes 1 and 2 set out practical co-operation arrangements in on-the-spot verifications and investigations based on standing requests for assistance. In order to avoid duplication and unnecessary burdens, it is proposed that the requested authority should first transmit the information and documents internally available. If the requesting authority, taking also into account the requested authority's views, determines that additional information is necessary, the two authorities should consult one another to agree on the modalities to carry out further investigatory activities. In order to render cross-border verifications and investigations more efficient, it is proposed that, unless agreed otherwise by the authorities, on-the-spot verifications and investigations are to be conducted by the requested authority.

8. As provided by Article 101(1) of the UCITS Directive, the requested authority does not need to have an independent interest in the investigation.

9. When it is agreed that the personnel of the requesting authority accompany the personnel of the requested authority, the overall control of the verification or investigation should remain within the hands of the requested authority, in accordance with Article 101(5) of the UCITS Directive. This should apply also to hearings/interviews conducted in the territory of the requested authority (see also the *Best Practice Guidelines for the gathering of a statement by the requesting authority in the presence of personnel from the requesting authority*, Ref. CESR/05-044).

10. Possible issues related to the allocation of costs should be dealt with bilaterally by the concerned

(l) the winding-up and liquidation of the UCITS;
(m) where applicable, the content of the unit-holder register;
(n) the licensing and supervision fees regarding the UCITS;
(o) the exercise of unit holders' voting rights and other unit holders' rights related to points (a) to (m).

[27] According to Article 19(1)(2) of the UCITS Directive, the competent authority of the management company's home Member State is responsible for supervising compliance with respect to the organisation of the management company, including delegation arrangements, risk management procedures, prudential rules and supervision, internal procedures and the management company's reporting requirements.

competent authorities.

11. As set out in Article 101(6) of the UCITS Directive, refusal to provide co-operation is allowed only under the following circumstances:

    Competent authorities may refuse to exchange information as provided for in paragraph 2 or to act on a request for co-operation in carrying out an investigation or on-the-spot verification as provided for in paragraph 4 only where:
    - *such an investigation, on-the-spot verification or exchange of information might adversely affect the sovereignty, security or public policy of the Member State addressed;*
    - *judicial proceedings have already been initiated in respect of the same actions and the same persons before the authorities of the Member State addressed;*
    - *final judgment has already been delivered in the Member State addressed in respect of the same persons and the same actions.*

12. A refusal to provide co-operation may be brought to the attention of CESR. Specific procedures may be subsequently defined at level 3.

Box 4

Additional rules on-the-spot verification and investigation in case of cross-border management

1. In case of cross-border management, the competent authorities of the management company and the competent authorities of the UCITS home Member State shall notify to each other the on-site inspections they wish to undertake. Each of the notified competent authorities may request without delay that the notifying competent authority carries out on-the-spot verifications on matters falling within the scope of its authority.

The authorities shall inform each other of any serious irregularities discovered in carrying out their investigations and on-the-spot verifications and measures adopted to correct the violations..

2. Competent authorities might agree the establishment of special framework of co-operation to the purpose of carrying out joint supervision or joint investigation on passported management companies and relevant branches or on other common matters in accordance with standards defined by CESR.

3. In case two or more competent authorities agree to establish such framework for joint supervision and investigation among themselves, they should design appropriate arrangements in order to define the procedure for proposing the commencement and conducting the joint supervision or investigation. In particular, before a joint supervision or investigation is commenced, the competent authorities should agree upon adequate way for allocating responsibilities and work of their respective personnel in a view of avoiding duplications and unnecessary supervisory burdens.

5. Competent authorities should also define the procedures for sharing the outcome of their work and discuss, if necessary, the follow up actions to the investigation.

6. Each competent authority should retain legal responsibility for its role in the conduct of enquiries and for compliance with the provisions of the UCITS Directive and other national laws.

7. A competent authority might wish to delegate tasks for the performance of supervisory activities in accordance with standards defined by CESR to a competent authority established in another Member State. In such a case the agreement of the competent authority to which the tasks are to be delegated is necessary.

Explanatory text

13. In cases of cross-border management a more intensive co-operation is necessary between all competent authorities involved (i.e. according to the language of the UCITS Directive: the competent authorities of: (i) the management company's home Member State, (ii) the management company's host Member State, and (iii) the UCITS home Member State). Co-operation may be designed in the form of joint supervision conducted through common oversight programmes agreed among the competent authorities. This may require common determination of the risks to be monitored, possible adoption of a standardised methodology, organisation of joint meetings and visits, and sharing of assessment letters. However, as a minimum there should be an obligation on each competent authority to notify the performance of on-site inspections to the other authorities, who could ask for the outcome of such work to be shared or even request specific supervisory activities to be carried out on their behalf. This should avoid unnecessary burdens on firms and duplication of work. It is understood that this process of notification should not jeopardise the supervisory action by the notifying competent authority. Therefore, such authority can start the on-site inspection without waiting for the prior reply of the notified authority.

14. In particular, in order to ensure an appropriate co-ordination of their supervisory activity, competent authorities may wish to define a protocol for joint supervision similar to that envisaged under the CESR Protocol for the supervision of branches under MiFID (Ref. CESR/07-672). Each competent authority should use the supervisory tools and practices it is accustomed to using in a national context unless otherwise agreed. Co-operation arrangements should be aimed at enhancing the efficiency of the supervisory activity and reducing the burdens for the supervised entities.

15. Where it would assist in the effective investigation of the alleged violations, competent authorities may agree to carry out a joint investigation. In such cases, the authorities should consult one another to define modalities to carry out an effective investigation, taking into account the need to avoid duplication and unnecessary supervisory burdens.

16. Article 2 of the CESR MMoU states:

    'Without prejudice to the provisions set forth by the EU legislation relating to the inspection of branches, the Authorities will consider (to the extent permitted by law) conducting joint investigations in cases where the request for assistance concerns violations of laws or regulations, where it would assist in the effective investigation of the alleged violations. The Authorities should consult to define the procedures to be adopted for conducting any joint investigation, the sharing of work and responsibilities and the follow up actions to such investigations.'

17. Moreover, the IOSCO guide on Joint Cross-border investigations and related proceedings provides examples of important issues to be taken into account in conducting joint investigations. In particular, it is acknowledged that, 'if a joint investigation is to be effective, co-operating regulators will need to discuss as many of these issues as possible at the outset and continue to communicate with each other as the need arises'. According to the IOSCO 2009 Guide, regulators should, inter alia:

    - discuss their understanding of the suspected misconduct;
    - identify the laws and regulations that may have been violated in their respective jurisdictions and the range of possible sanctions;
    - identify the channels and methods of communication;
    - explore the enforcement interests that other domestic authorities may have in the investigations;
    - discuss the timeframe within which to complete the investigations; and
    - discuss the adoption of possible precautionary measures and filing of enforcement

actions.

CHAPTER 2

EXCHANGE OF INFORMATION

Implementation of Article 105 of the UCITS Directive

Introduction

1. It is crucial in both national and cross-border management situations that each competent authority receives all information necessary to perform its duties under the UCITS Directive.

2. Article 101(1) of the UCITS Directive provides that the competent authorities of the Member States shall cooperate with each other whenever necessary for the purpose of carrying out their duties under this Directive or of exercising their powers under this Directive or under national law. In particular, they shall immediately supply one other with the information necessary for the above-mentioned purposes.

3. Article 105 of the UCITS Directive empowers the Commission to adopt implementing measures relating to the procedures for exchange of information between competent authorities. As in the case of on-the-spot verification and investigation, the powers granted to the Commission concerning information sharing between competent authorities are not solely related to the management company passport. Information sharing between competent authorities underpins all cross-border actions involving UCITS.

4. CESR is requested under the Commission's mandate:

   - to define the content of the procedure to be followed when competent authorities intend to exchange information;
   - to indicate if there are areas which could be more effectively regulated at level 3.

Exchange of information

Box 5

Exchange of information upon request

1. The exchange of information between competent authorities should take place in accordance with a request made and processed under the requirements of the UCITS Directive and the CESR MMoU.

Routine exchange of information

Competent authorities should ensure that information is immediately supplied to the other competent authority in the cases when the UCITS Directive requires information to be exchanged without prior specific request. In particular, when:

(i) any decision to withdraw authorisation, or any other serious measure is taken against a UCITS, or any suspension of the issue, re-purchase or redemption imposed upon it, then the authorities of the UCITS home Member State shall communicate without delay any such decision or measure to the

authorities of the UCITS host Member States and, if the management company of a UCITS is situated in another Member State, to the competent authorities of the management company's home Member State;

(ii) any measures is taken by the management company's host Member State pursuant to Article 21 which involve measures and penalties imposed on a management company or restrictions on a management company's activities, then, insofar as it is necessary for the purpose of exercising their powers of supervision, the competent authorities of the management company's home Member State shall be informed by the competent authorities of the management company's host Member State of such measures;

(iii) any problem is identified at the level of the management company and which would materially affect the ability of the management company to properly perform its duties with respect to the UCITS or of any breach of the requirements under Chapter III, then the competent authorities of the management company's home Member State shall notify, without delay, the competent authorities of the UCITS home Member State of any such problem.

Unsolicited exchange of information

Each competent authority shall communicate to the other competent authority, without prior request and undue delay, any relevant factual information in which the other authority, as determined in good faith by the communicating authority, is likely to have a material interest with regard to the discharge of its duties under the UCITS Directive.

1. Information may be exchanged upon request (ad hoc requests for information) or without previous request, in the cases established by the UCITS Directive or on an unsolicited basis when considered appropriate in good faith by the authority providing the information.

2. Requests for co-operation and exchange of information should be made in writing, in accordance with the procedures set out in the CESR MMoU. In case of urgency, requests and replies to such requests may be transmitted orally provided that the requests are confirmed in writing. Requests should be acknowledged without undue delay.

3. The requesting authority should ensure that the request contains sufficient information to enable the requested authority to fulfil the request.

4. As regards information already internally available, this information should be immediately transmitted. In all other cases the requested authority should take immediately any necessary step, including forwarding the request to other national competent authorities, to gather the requested information.

5. If the requested authority is not able to supply the requested information immediately, the requesting authority should be informed of the reasons.

6. Routine exchange of information relates to information which has to be provided to the competent authority of another Member State, in accordance with the UCITS Directive without prior specific request (i.e. information to be exchanged under Articles 108(2)[28], 109(2) and

[28] Article 108(2) of the UCITS Directive provides that: 'Any decision to withdraw authorisation, or any other serious measure taken against a UCITS, or any suspension of the issue, re-purchase or redemption imposed upon it, shall be communicated without delay by the authorities of the UCITS home Member State to the authorities of the UCITS host Member States and, if the management company of a UCITS is situated in another Member State, to the competent authorities of the management company's home Member State'.

109(3)[29] of the UCITS Directive). In these cases, the information should be supplied immediately to the other competent authorities.

3. Exchange of information and consultation for supervisory purposes. Additional provisions in relation to cross-border management

Box 6

Cross-border management

1. Competent authorities should be able to provide each other any assistance which is necessary to perform their duties under the UCITS Directive and establish appropriate information flows, including in connection with:

- the procedures for the authorisation of a management company to pursue activities within the territory of another Member State, by establishing a branch or under the freedom to provide services, pursuant to Articles 17 and 18 of the UCITS Directive;

- the procedures for the authorisation of a management company to manage a UCITS established in another Member State, pursuant to Article 20 of the UCITS Directive; and

- the on-going supervision of passported management companies and relevant managed UCITS..

2. Competent authorities may agree to meet periodically, as necessary, or on a case by case basis to discuss issues of common interests relating to the supervision of passported management companies and to improve co-operation between the authorities.

3. Without prejudice to any of the authorities domestic competences and responsibilities, the issues to be discussed at these meetings may include, but will not be limited to:

(a) assessment of risks affecting entities subject to the authorities supervision;

(b) material and substantive developments of the market;

(c) compliance with the EU provisions;

(d) improving co-operation and co-ordination between the authorities.

7. In the context of the cross-border management, a series of additional cases in which information should be considered as routinely and supplied without delay should be established. These cases should cover information necessary in the event of authorisation of the UCITS' being managed by a passported management company and during the life of such UCITS. In order to ensure an appropriate co-ordination of their supervisory activity, competent authorities may wish to define a framework for the practical arrangements with a view to facilitating the

[29] Article 109(2) provides that 'Insofar as it is necessary for the purpose of exercising their powers of supervision, the competent authorities of the management company's home Member State shall be informed by the competent authorities of the management company's host Member State of any measures taken by the management company's host Member State pursuant to Article 21 which involve measures and penalties imposed on a management company or restrictions on a management company's activities'.
Article 109(3) states that: 'The competent authorities of the management company's home Member State shall notify, without delay, the competent authorities of the UCITS home Member State of any problem identified at the level of the management company and which would materially affect the ability of the management company to properly perform its duties with respect to the UCITS or of any breach of the requirements under Chapter III.'

passport notification and consultation processes, similar to that envisaged under the CESR Protocol on MiFID Passport Notifications (Ref. CESR/07-317b).

8. Information flows among competent authorities should be organised in such a way as to reduce the burden borne by competent authorities and supervised entities.

9. In a number of cases information obtained from the UCITS/management company will be of relevance for both authorities (namely in the field of periodic reporting). In such cases it could be useful to set up national or centralised databases managed at the level of colleges of supervisors or under other types of agreement. This would reduce the burden on the industry.